

TAIWAN SEMICONDUCTOR MANUFACTURING CO LTD

Form 20-F

April 15, 2008

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**SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 20-F**

- o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**
OR
- o **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007
OR
- o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____
OR
- o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number 1-14700
(Exact Name of Registrant as Specified in Its Charter)

Taiwan Semiconductor Manufacturing Company
Limited
(Translation of Registrant's Name Into English)

Republic of China
(Jurisdiction of Incorporation or Organization)

No. 8, Li-Hsin Road 6
Hsinchu Science Park
Hsinchu, Taiwan
Republic of China
(Address of Principal Executive Offices)

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

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Shares, par value NT\$10.00 each	The New York Stock Exchange, Inc.*

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

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2007, 25,627,103,715 Common Shares, par value NT\$10 each were outstanding.

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 (15)(d) of the Securities Exchange Act of 1934. Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark 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

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

* Not for trading, but only in connection with the listing on the New York Stock Exchange, Inc. of American Depositary Shares representing such Common Shares

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TSMC and tsmc are our registered trademarks and NEXSYS, 1T RAM and Virtual fab are trademarks used by us.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This annual report includes statements that are, or may be deemed to be, forward-looking statements within the meaning of U.S. securities laws. The terms anticipates, expects, may, will, should and other similar expressions identify forward-looking statements. These statements appear in a number of places throughout this annual report and include statements regarding our intentions, beliefs or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies and the industries in which we operate.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. Forward-looking statements are not guarantees of future performance and our actual results of operations, financial condition and liquidity, and the development of the industries in which we operate may differ materially from those made in or suggested by the forward-looking statements contained in this annual report. Important factors that could cause those differences include, but are not limited to:

- the volatility of the semiconductor and microelectronics industry;
- overcapacity in the semiconductor industry;
- the increased competition from other companies and our ability to retain and increase our market share;
- our ability to develop new technologies successfully and remain a technological leader;
- our ability to maintain control over expansion and facility modifications;
- our ability to generate growth and profitability;
- our ability to hire and maintain qualified personnel;
- our ability to acquire required equipment and supplies necessary to meet business needs;
- our reliance on certain major customers;
- the political stability of our local region; and
- general local and global economic conditions.

Forward-looking statements include, but are not limited to, statements regarding our strategy and future plans, future business condition and financial results, our capital expenditure plans, our capacity expansion plans, our expansion plans in mainland China, expectations as to the commercial production using 65-nanometer and more advanced technologies, technological upgrades, investment in research and development, future market demand, future regulatory or other developments in our industry. Please see Item 3. Key Information Risk Factors for a further discussion of certain factors that may cause actual results to differ materially from those indicated by our forward-looking statements.

Table of Contents**PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION**Selected Financial and Operating Data**

The selected income statement data, cash flow data and other financial data for the years ended December 31, 2005, 2006 and 2007, and the selected balance sheet data as of December 31, 2006 and 2007, set forth below, are derived from our audited consolidated financial statements included herein, and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements, including the notes thereto. The selected income statement data, cash flow data and other financial data for the years ended December 31, 2003 and 2004 and the selected balance sheet data as of December 31, 2003, 2004 and 2005, set forth below, are derived from our audited consolidated financial statements not included herein. The consolidated financial statements have been prepared and presented in accordance with accounting principles generally accepted (GAAP or R.O.C. GAAP) in the Republic of China (R.O.C. or Taiwan), which differ in some material respects from accounting principles generally accepted in the United States of America (U.S. GAAP) as further explained under note 30 to our consolidated financial statements included herein.

	Year ended and as of December 31,					
	2003	2004	2005	2006	2007	2007
	NT\$	NT\$	NT\$	NT\$	NT\$	US\$
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Income Statement Data:						
R.O.C. GAAP						
Net sales	202,997	257,213	266,565	317,407	322,630	9,948
Cost of sales	(128,113)	(141,394)	(148,362)	(161,597)	(180,280)	(5,559)
Gross profit	74,884	115,819	118,203	155,810	142,350	4,389
Operating expenses	(23,583)	(27,337)	(27,234)	(28,545)	(30,628)	(944)
Income from operations	51,301	88,482	90,969	127,265	111,722	3,445
Non-operating income and gains ⁽¹⁾	5,669	8,581	9,399	9,705	11,934	368
Non-operating expenses and losses ⁽¹⁾	(5,791)	(5,097)	(6,105)	(3,608)	(2,014)	(62)
Income before income tax and minority interest	51,179	91,966	94,263	133,362	121,642	3,751
Income tax benefit (expense)	(3,923)	363	(630)	(7,774)	(11,710)	(361)
Income before cumulative effect of changes in accounting principles	47,256	92,329	93,633	125,588	109,932	3,390
Cumulative effect of changes in accounting principles				1,607		

Income before minority interest	47,256	92,329	93,633	127,195	109,932	3,390
Minority interest in loss (income) of subsidiaries	3	(13)	(58)	(185)	(755)	(23)
Net income attributable to shareholders of the parent	47,259	92,316	93,575	127,010	109,177	3,367
Basic earnings per share ⁽²⁾	1.78	3.50	3.55	4.82	4.14	0.13
Diluted earnings per share ⁽²⁾	1.78	3.50	3.55	4.81	4.14	0.13
Basic earnings per ADS equivalent ⁽²⁾	8.89	17.49	17.76	24.08	20.72	0.64

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	Year ended and as of December 31,					2007 US\$
	2003 NT\$	2004 NT\$	2005 NT\$	2006 NT\$	2007 NT\$	
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Diluted earnings per ADS equivalent ⁽²⁾	8.89	17.49	17.75	24.06	20.70	0.64
Basic weighted average shares outstanding ⁽²⁾	26,470	26,391	26,349	26,375	26,347	26,347
Diluted weighted average shares outstanding ⁽²⁾	26,479	26,396	26,360	26,399	26,368	26,368
U.S. GAAP						
Net sales	203,600	260,035	267,028	317,979	323,221	9,967
Cost of sales ⁽³⁾	(133,493)	(154,785)	(161,808)	(179,175)	(202,046)	(6,230)
Operating expenses ⁽³⁾	(27,369)	(32,191)	(32,764)	(37,050)	(44,775)	(1,381)
Income from operations	42,738	73,059	72,456	101,754	76,400	2,356
Income before income tax and minority interest	42,441	76,838	75,983	106,647	85,973	2,651
Income tax expense	(3,881)	(508)	(483)	(10,954)	(14,012)	(432)
Cumulative effect of changes in accounting principles				38		
Net income	38,661	76,253	75,418	95,711	71,658	2,210
Cumulative preferred dividends	(184)					
Income attributable to common shareholders	38,477	76,253	75,418	95,711	71,658	2,210
Basic earnings per share ⁽⁴⁾	1.54	3.03	2.97	3.72	2.74	0.08
Diluted earnings per share ⁽⁴⁾	1.54	3.03	2.96	3.71	2.74	0.08
Basic earnings per ADS equivalent ⁽⁴⁾	7.70	15.15	14.83	18.58	13.70	0.42
Diluted earnings per ADS equivalent ⁽⁴⁾	7.70	15.15	14.82	18.56	13.69	0.42
Basic weighted average shares outstanding ⁽⁴⁾	24,971	25,170	25,434	25,757	26,149	26,149
Diluted weighted average shares outstanding ⁽⁴⁾	24,981	25,174	25,445	25,778	26,170	26,170
Balance Sheet Data:						
R.O.C. GAAP						
Working capital ^{(1) (5)}	136,121	120,574	177,179	213,457	201,116	6,202
Long-term investments ⁽¹⁾	10,748	38,058	42,383	53,895	36,461	1,124
Properties	211,854	258,911	244,823	254,094	260,252	8,025
Goodwill	8,721	7,116	6,011	5,985	5,988	185
Total assets	407,401	499,454	519,510	587,485	570,865	17,603
Long term bank borrowing	8,800	1,915	663	654	1,722	53

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Long-term bonds payable	30,000	19,500	19,500	12,500	12,500	385
Guaranty deposit-in and other liabilities ⁽⁵⁾⁽⁶⁾	8,876	15,079	17,986	18,333	17,251	532
Total liabilities	78,098	100,413	73,271	78,347	80,179	2,472
Capital stock	202,666	232,520	247,300	258,297	264,271	8,149
Cash dividend on common shares		12,160	46,504	61,825	77,489	2,389
Shareholders' equity attributable to shareholders of the parent	329,214	398,965	445,631	507,981	487,092	15,020
Minority interest in subsidiaries	89	76	608	1,157	3,594	111
U.S. GAAP						
Goodwill	47,287	46,757	46,993	46,940	46,926	1,447
Total assets	439,853	536,286	558,919	626,108	610,843	18,836
Total liabilities	81,977	108,416	80,962	92,549	94,021	2,899
Capital Stock	202,666	232,520	247,300	258,297	264,271	8,149
Mandatory redeemable preferred stock						
Shareholders' equity attributable to common shareholders of the parent	357,173	427,125	477,297	532,403	513,228	15,826
Minority interest in subsidiaries	703	745	660	1,156	3,594	111

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	Year ended and as of December 31,					
	2003	2004	2005	2006	2007	2007
	NT\$	NT\$	NT\$	NT\$	NT\$	US\$
	(in millions, except for percentages, earnings per share and per ADS, and operating data)					
Other Financial Data:						
R.O.C. GAAP						
Gross margin	37%	45%	44%	49%	44%	44%
Operating margin	25%	34%	34%	40%	35%	35%
Net margin	23%	36%	35%	40%	34%	34%
Capital expenditures	37,871	81,095	79,879	78,737	84,001	2,590
Depreciation and amortization	69,161	69,819	75,649	73,715	80,005	2,467
Cash provided by operating activities ⁽¹⁾	116,037	153,523	157,225	204,997	183,766	5,667
Cash used in investing activities ⁽¹⁾⁽⁷⁾	(53,702)	(148,359)	(77,652)	(119,724)	(70,689)	(2,180)
Cash used in financing activities ⁽⁷⁾	(27,073)	(32,181)	(57,969)	(63,783)	(135,410)	(4,175)
Net cash inflow (outflow)	35,199	(28,687)	22,181	21,353	(22,851)	(705)
Operating Data:						
Wafer (200mm equivalent) shipment ⁽⁸⁾	3,700	5,008	5,622	7,215	8,005	8,005
Billing Utilization Rate ⁽⁹⁾	92%	105%	94%	102%	93% ⁽¹⁰⁾	93% ⁽¹⁰⁾

(1) As a result of the adoption of the newly released R.O.C. Statements of Financial Accounting Standards No. 34, Financial Instruments: Recognition and Measurement (R.O.C. SFAS No. 34), and R.O.C. Statements of Financial Accounting Standards No. 36, Financial

Instruments:
Disclosure and
Presentation
(R.O.C. SFAS
No. 36), the
balances in 2004
and 2005 were
reclassified to be
consistent with the
classification used
in our
consolidated
financial
statements for
2006 included
herein. Amounts
in 2004 reflect the
reclassification of
NT\$2,565 million
gains from
non-operating
expenses and
losses to
non-operating
income and gains,
NT\$44 million
from long-term
investments to
current
investments in
marketable
financial
instruments, and
NT\$372 million
from cash used in
investing activities
to cash provided
by operating
activities.
Amounts in 2005
reflect the
reclassification of
NT\$2,331 million
gains from
non-operating
expenses and
losses to
non-operating
income and gains,
NT\$46 million
from long-term

investments to current investments in marketable financial instruments, and NT\$212 million from cash used in investing activities to cash provided by operating activities. Balance in 2003 was not reclassified accordingly. See note 4 to our consolidated financial statements for additional details about these new accounting standards.

- (2) Retroactively adjusted for all subsequent stock dividends and employee stock bonuses.
- (3) Amounts in 2006 include share-based compensation expenses as a result of the adoption of U.S. Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, effective January 1, 2006. See note 30.i. to our consolidated financial statements for additional details

about this new accounting standard. Amounts in 2003 and 2005 reflect the reclassification of NT\$1,625 million and NT\$159 million, respectively, from net non-operating expenses to operating expenses. Amounts in 2004 reflect the reclassification of NT\$232 million from net non-operating income to operating expenses.

- (4) Retroactively adjusted for all subsequent stock dividends.
- (5) Amounts in 2003 reflect the reclassification of NT\$727 million from current liabilities to long-term liabilities.
- (6) Consists of other long term payables and total other liabilities.
- (7) Amounts in 2003 reflect the reclassification of NT\$300 million from cash used in investing activities to cash used in financing

activities.

- (8) In thousands.
- (9) Billing Utilization
Rate is equal to
annual wafer
shipment divided
by annual
capacity.
- (10) Capacity includes
wafers committed
by Vanguard.

Exchange Rates

We publish our financial statements in New Taiwan dollars, the lawful currency of the R.O.C. In this annual report, \$, US\$ and U.S. dollars mean United States dollars, the lawful currency of the United States, and NT\$ and NT do mean New Taiwan dollars. This annual report contains translations of certain NT dollar amounts into U.S. dollars at specified rates solely for the convenience of the reader. Unless otherwise noted, all translations from NT dollars to U.S. dollars and from U.S. dollars to NT dollars were made at the noon buying rate in The City of New York for cable transfers in NT dollars per U.S. dollar as certified for customs purposes by the Federal Reserve Bank of New York as of December 31, 2007, which was NT\$32.43 to US\$1.00 on that date. On April 14, 2008, the noon buying rate was NT\$30.31 to US\$1.00.

The following table sets forth, for the periods indicated, information concerning the number of NT dollars for which one U.S. dollar could be exchanged based on the noon buying rate for cable transfers in NT dollars as certified for customs purposes by the Federal Reserve Bank of New York.

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	Average ⁽¹⁾	NT dollars per U.S. dollar		Period-End
		High	Low	
2003	34.41	34.98	33.72	33.99
2004	33.37	34.16	31.74	31.74
2005	32.16	33.77	30.65	32.80
2006	32.51	33.31	31.28	32.59
2007	32.82	33.41	32.26	32.43
October 2007	32.55	32.61	32.39	32.39
November 2007	32.33	32.39	32.26	32.26
December 2007	32.41	32.53	32.30	32.43
January 2008	32.36	32.49	32.15	32.15
February 2008	31.61	32.03	30.90	30.92
March 2008	30.58	31.09	29.99	30.37
April 2008 (through April 14, 2007)	30.38	30.52	30.29	30.31

(1) Annual averages calculated from month-end rates.

No representation is made that the NT dollar or U.S. dollar amounts referred to herein could have been or could be converted into U.S. dollars or NT dollars, as the case may be, at any particular rate or at all.

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf and that such factors may adversely affect our business and financial status and therefore the value of your investment:

Risks Relating to Our Business

Since we are dependent on the highly cyclical semiconductor and microelectronics industries, which have experienced significant and sometimes prolonged periods of downturns and overcapacity, our revenues, earnings and margins may fluctuate significantly.

The semiconductor market and microelectronics industries have historically been cyclical and subject to significant and often rapid increases and decreases in product demand. Our semiconductor foundry business is affected by market conditions in such highly cyclical semiconductor and microelectronics industries. Most of our customers operate in these industries. Variations in order levels from our customers result in volatility in our revenues and earnings. From time to time, the semiconductor and microelectronics industries have experienced significant, and sometimes prolonged periods of downturns and overcapacity. Because our business is, and will continue to be, dependent on the requirements of semiconductor and microelectronics companies for our services, periods of downturns and overcapacity in the general semiconductor and microelectronics industries lead to reduced demand for overall semiconductor foundry services worldwide, including our services. If we cannot take appropriate actions such as reducing our costs to sufficiently offset declines in demand, our revenues, margin and earnings will suffer during downturns and periods of overcapacity.

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Decreases in demand and average selling prices for products that contain semiconductors may adversely affect demand for our products and may result in a decrease in our revenues and earnings.

A vast majority of our sales revenue is derived from customers who use our services in personal computers, communication devices and consumer electronics products. Any significant decrease in the demand for the products may decrease the demand for overall global semiconductor foundry services, including our services and may adversely affect our revenues. In addition, the historical and current trend of declining average selling prices of end use applications places pressure on the prices of the components that go into these end use applications. If the average selling prices of end use applications continue decreasing, the pricing pressure on components produced by us may lead to a reduction of our revenue.

If we are unable to compete effectively in the highly competitive foundry segment of the semiconductor industry, we may lose customers and our profit margin and earnings may decrease.

The markets for our foundry services are highly competitive both in Taiwan and internationally. We compete with other dedicated foundry service providers, as well as integrated device manufacturers. Some of these companies may have access to more advanced technologies and greater financial and other resources than us. Our competition may, from time to time, also decide to undertake aggressive pricing initiatives in one or more technology nodes. Competitive activities may cause us to lose customers or to decrease our average selling prices or both.

If we are unable to remain a technological leader in the semiconductor industry, we may become less competitive.

The semiconductor industry and the technologies used in it are constantly changing. If we do not anticipate these changes in technologies and rapidly develop new and innovative technologies or our competitors unforeseeably gain sudden access to more advanced technologies, we may not be able to provide advanced foundry services on competitive terms. Although we have concentrated on maintaining a competitive edge in research and development, if we fail to achieve advances in technology or processes, or to obtain access to advanced technologies or processes developed by others, we may become less competitive.

If we are unable to manage our expansion and the modification of our production facilities effectively, our growth prospects may be limited.

We have been ramping up the production of our 300mm wafer fabs in the Hsinchu Science Park and Tainan Science Park, respectively, since 2004. In 2007, the capacity of our 300mm wafer fabs increased from 93,700 wafer per month in 2006 to 130,700 wafer per month in 2007. Expansion and modification of our production facilities will, among other factors, increase our costs. For example, we will need to purchase additional equipment, train personnel to operate the new equipment or hire additional personnel. If we do not increase our net sales accordingly in order to offset these higher costs, our financial performance may be adversely affected.

We may not be able to implement our planned growth or development if we are unable to accurately forecast and sufficiently meet our future capital requirements.

Capital requirements are difficult to plan in the highly dynamic, cyclical and rapidly changing semiconductor industry. We will continue to need significant capital to fund our operations and growth. Although we currently have adequate financial resources and excellent relations with financial institutions who are willing to consider extending credit to us if needed on market terms, our continued ability to obtain sufficient external financing in the future is subject to a variety of uncertainties, including:

our future financial condition, results of operations and cash flow;

general market conditions for financing activities by semiconductor companies; and

social, economic, financial, political and other conditions in Taiwan and elsewhere.

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Sufficient external financing may not be available to us on a timely basis, on general market terms, or at all. As a result, we may be forced to curtail our expansion and modification plans or delay the deployment of new or expanded services until we obtain such financing.

We may not be able to implement our planned growth or maintain our leading position if we are unable to recruit and retain qualified management and skilled technical and service personnel.

We depend on the continued services and contributions of our executive officers and skilled technical and other personnel. Our business could suffer if we lose, for whatever reasons, the services and contributions of some of these personnel and we cannot adequately replace them. We may be required to increase the number of employees in connection with any business expansion, and since there is intense competition for the recruitment of these personnel, we cannot ensure that we will be able to fulfill our personnel requirements in a timely manner.

We may be unable to obtain in a timely manner and at a reasonable cost the equipment necessary for us to remain competitive.

Our operations and ongoing expansion plans depend on our ability to obtain a significant amount of equipment and related services from a limited number of suppliers in a market that is characterized, from time to time, by intense demand, limited supply and long delivery cycles. During such times, supplier-specific or industry-wide lead times for delivery can be as long as four to ten months or more. To better manage potential shortage, we have implemented various business models and risk management contingencies with suppliers to shorten the procurement lead time. We also provide our projected demand for various items to many of our equipment suppliers to help them plan their production in advance. If we are unable to obtain equipment in a timely manner and at a reasonable cost, we may be unable to fulfill our customers' orders, which could negatively impact our financial condition and results of operations. ***Our revenue and profitability may decline if we are unable to obtain adequate supplies of raw materials in a timely manner and at reasonable prices.***

Our production operations require that we obtain adequate supplies of raw materials, such as silicon wafers, gases, chemicals, and photoresist, on a timely basis. Shortages in the supply of some materials experienced by specific vendors or by the semiconductor industry generally have in the past resulted in occasional industry-wide price adjustments and delivery delays. Also, since we procure some of our raw materials from sole-source suppliers, there is a risk that our need for such raw materials may not be timely met. Our revenue and earnings could decline if we are unable to obtain adequate supplies of the necessary raw materials in a timely manner or if there are significant increases in the costs of raw materials that we cannot pass on to our customers.

If the Ministry of Economic Affairs uses a substantial portion of our production capacity, we will not be able to service our other customers.

According to our agreement with the Industrial Technology Research Institute of Taiwan, or ITRI, the Ministry of Economic Affairs of the R.O.C., or an entity designated by the Ministry of Economic Affairs, has an option to purchase up to 35% of certain of our capacity, if our outstanding commitments to our customers are not prejudiced. Although the Ministry of Economic Affairs has never exercised this option, if this option is exercised to any significant degree during tight market conditions, we may not be able to provide services to all of our other customers unless we are able to increase our capacity accordingly or outsource such increased demand and in a timely manner. ***Any inability to obtain, preserve and defend our technologies and intellectual property rights could harm our competitive position.***

Our ability to compete successfully and to achieve future growth will depend in part on the continued strength of our intellectual property portfolio. While we actively enforce and protect our intellectual property rights, there can be no assurance that our efforts will be adequate to prevent the misappropriation or improper use of our proprietary technology, trade secrets, software or know-how. Also, we cannot assure you that, as our business or business models expand into new areas, we will be able to develop independently the technology, trade secrets, software or know-how necessary to conduct our business or that we can do so without infringing the intellectual property rights of others. As a result, we may have to rely increasingly on licensed technology from others. To the extent that we rely on licenses from others, there can be no assurance that we will be able to obtain any or all of the necessary licenses in the future on terms we consider reasonable or at all. The lack of necessary licenses could expose us to claims for damages and/or injunctions from third parties, as well as claims for indemnification by our customers in instances where we have contractually agreed to indemnify our customers against damages resulting from infringement claims.

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We have received, from time-to-time, communications from third parties asserting that our technologies, manufacturing processes, the design of the integrated circuits made by us or the use by our customers of semiconductors made by us may infringe their patents or other intellectual property rights. And, because of the nature of the industry, we may continue to receive such communications in the future. In some instances, these disputes have resulted in litigation. If we fail to obtain or maintain certain government, technology or intellectual property licenses and, if litigation relating to alleged intellectual property matters occurs, it could prevent us from manufacturing or selling particular products or applying particular technologies, which could reduce our opportunities to generate revenues. See Item 8. Financial Information Legal Proceedings for a further discussion.

We are subject to the risk of loss due to explosion and fire because some of the materials we use in our manufacturing processes are highly combustible.

We and many of our suppliers use highly combustible and toxic materials in manufacturing processes and are therefore subject to the risk of loss arising from explosion, fire, or environmental excursions which cannot be completely eliminated. Although we maintain many overlapping risk prevention and protection systems, as well as comprehensive fire and casualty insurance, including insurance for loss of property and loss of profit resulting from business interruption, our risk management and insurance coverage may not be sufficient to cover all of our potential losses. If any of our fabs were to be damaged or cease operations as a result of an explosion, fire, or environmental excursions, it could reduce our manufacturing capacity and may cause us to lose important customers, thereby having a potentially material adverse impact on our financial performance.

Any impairment charges may have a material adverse effect on our net income.

Under R.O.C. GAAP and U.S. GAAP, we are required to evaluate our long-lived assets and intangible assets for impairment whenever there is an indication of impairment. If certain criteria are met, we are required to record an impairment charge. We are also required under R.O.C. GAAP and U.S. GAAP to evaluate goodwill for impairment at least on an annual basis or whenever a triggering event or an indication of impairment occurs.

We currently are not able to estimate the extent or timing of any impairment charge for future years. Any impairment charge required may have a material adverse effect on our net income.

The determination of an impairment charge at any given time is based significantly on our expected results of operations over a number of years subsequent to that time. As a result, an impairment charge is more likely to occur during a period when our operating results are otherwise already depressed. See Item 5. Operating and Financial Review and Prospects Critical Accounting Policies for a discussion of our estimates made for determining an impairment charge.

The loss of or significant curtailment of purchases by any of our largest customers could adversely affect our results of operations.

While we generate revenue from hundreds of customers worldwide, our ten largest customers accounted for approximately 53% and 51% of our net sales in 2006 and 2007, respectively, and our largest customer accounted for approximately 10% and 11% of our net sales in 2006 and 2007, respectively. The loss of, or significant curtailment of purchases by, one or more of our top customers, including curtailments due to a change in the design or manufacturing sourcing policies or practices of these customers, or the timing of customer or distributor inventory adjustments, may adversely affect our results of operations and financial condition.

Table of Contents***Any failure to achieve and maintain effective internal controls could have a material adverse effect on our business, results of operations and the market price of our common shares and ADSs.***

Effective internal controls are necessary for us to provide reasonable assurance with respect to our financial reports and to effectively prevent fraud. If we cannot provide reasonable assurance with respect to our financial reports and effectively prevent fraud, our reputation and results of operations could be harmed.

We are required to comply with various R.O.C. and U.S. laws and regulations on internal controls. For example, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, beginning with the Annual Report on Form 20-F for the fiscal year ended December 31, 2006, we are required to furnish a report by management on our internal control over financial reporting, including management's assessment of the effectiveness of our internal control over financial reporting. Moreover, R.O.C. law requires us to establish internal control systems that would reasonably ensure the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. We are also required under R.O.C. law to file an internal control declaration within four months of the end of each fiscal year.

Internal controls may not prevent or detect misstatements because of their inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Therefore, even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. In addition, projections of any evaluation of effectiveness of internal controls to future periods are subject to the risk that the internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. If we fail to maintain the adequacy of our internal controls, including any failure to implement required new or improved controls, or if we experience difficulties in their implementation, our business and operating results could be harmed, we could fail to meet our reporting obligations, and there could be a material adverse effect on the market price of our common shares and ADSs.

Our global manufacturing, design and sales activities subject us to risks associated with legal, political, economic or other conditions or developments in various jurisdictions, including in particular the Republic of China (R.O.C.), which could negatively affect our business and financial status and therefore the market value of your investment.

Our principal executive officers and our principal production facilities are located in the R.O.C. and a substantial majority of our net revenues are derived from our operations in the R.O.C. In addition, we have operations worldwide and a significant percentage of our revenue come from sales to locations outside the R.O.C. Operating in the R.O.C. and overseas exposes us to changes in policies and laws, as well as the general political and economic conditions, security risks, health conditions and possible disruptions in transportation networks, in the various countries in which we operate, which could result in an adverse effect on our business operations in such countries and our results of operations as well as the market price and the liquidity of our ADSs and common shares.

For example, even though the R.O.C. and the People's Republic of China (PRC) have co-existed for the past 59 years and significant economic and cultural relations have been established during that time, the financial markets have viewed certain past developments in relations between the two sides as occasions to depress general market prices of the securities of Taiwanese companies, including our own. In addition, the R.O.C. government currently restricts transfer by Taiwanese companies of certain technologies to and certain types of investments by Taiwanese companies in Mainland China.

Our results of operations could be materially adversely affected by natural disasters or interruptions in the supply of utilities (such as water or electricity) in the locations in which we, our customers or suppliers operate.

We have manufacturing and other operations in locations subject to natural disasters such as severe weather and earthquakes as well as interruptions or shortages in the supply of utilities (such as water and electricity) that could disrupt operations. In addition, our suppliers and customers also have operations in such locations. For example, most of our production facilities, as well as many of our suppliers and customers and upstream providers of complementary semiconductor manufacturing services, are located in Taiwan, which is susceptible to earthquakes, typhoons, and has experienced droughts from time to time. In addition, we have sometimes suffered power outages caused by our major electricity supplier, the Taiwan Power Company, or other power consumers on the same power supply line, which have caused interruptions in our production schedule. A natural disaster or interruptions in the supply of utilities that

results in a prolonged disruption to our operations, or the operations of our customers or suppliers, may adversely affect our results of operations and financial condition.

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Fluctuations in exchange rates could result in foreign exchange losses.

Over half of our capital expenditures and manufacturing costs are denominated in currencies other than NT dollars, primarily in U.S. dollars, Japanese yen and Euros. More than 90% of our sales are denominated in U.S. dollars and currencies other than NT dollars. Therefore, any significant fluctuation to our disadvantage in such exchange rate may have an adverse effect on our financial condition. For example, during the period from January 1, 2008 to March 31, 2008, the U.S. dollar has depreciated 6.4% against the NT dollar, which may have a material impact on our results of operations. In addition, fluctuations in the exchange rate between the U.S. dollar and the NT dollar may affect the U.S. dollar value of our common shares and the market price of the ADSs and of any cash dividends paid in NT dollars on our common shares represented by ADSs. Please see Item 5. Operating and Financial Review and Prospects Inflation and Item 11. Quantitative and Qualitative Disclosures About Market Risk for a further discussion on the possible impact of other market factors on our results of operations.

Risks Relating to Ownership of ADSs

Your voting rights as a holder of ADSs will be limited.

Holders of American Depositary Receipts (ADRs) evidencing ADSs may exercise voting rights with respect to the common shares represented by these ADSs only in accordance with the provisions of our ADS deposit agreement. The deposit agreement provides that, upon receipt of notice of any meeting of holders of our common shares, the depositary bank will, as soon as practicable thereafter, mail to the holders (i) the notice of the meeting sent by us, (ii) voting instruction forms and (iii) a statement as to the manner in which instructions may be given by the holders.

ADS holders will not generally be able to exercise the voting rights attaching to the deposited securities on an individual basis. According to the R.O.C. Company Law, the voting rights attaching to the deposited securities must be exercised as to all matters subject to a vote of shareholders collectively in the same manner, except in the case of an election of directors. Election of directors is by means of cumulative voting. See Item 10. Additional Information Voting of Deposited Securities for a more detailed discussion of the manner in which a holder of ADSs can exercise its voting rights.

You may not be able to participate in rights offerings and may experience dilution of your holdings.

We may, from time to time, distribute rights to our shareholders, including rights to acquire securities. Under our ADS deposit agreement, the depositary bank will not distribute rights to holders of ADSs unless the distribution and sale of rights and the securities to which these rights relate are either exempt from registration under the United States Securities Act of 1933, as amended, or the Securities Act, with respect to all holders of ADSs, or are registered under the provisions of the Securities Act. Although we may be eligible to take advantage of certain exemptions for rights offerings by certain foreign companies, we can give no assurance that we can establish an exemption from registration under the Securities Act, and we are under no obligation to file a registration statement with respect to any such rights or underlying securities or to endeavor to have such a registration statement declared effective. In addition, if the depositary bank is unable to obtain the requisite approval from the Central Bank of the Republic of China (Taiwan) for the conversion of the subscription payments into NT dollars or if the depositary determines that it is unlikely to obtain this approval, we may decide with the depositary bank not to make the rights available to holders of ADSs. See

Item 10. Additional Information Foreign Investment in the R.O.C. and Item 10. Additional Information Exchange Controls in the R.O.C. . Accordingly, holders of ADSs may be unable to participate in our rights offerings and may experience dilution of their holdings as a result.

If the depositary bank is unable to sell rights that are not exercised or not distributed or if the sale is not lawful or reasonably practicable, it will allow the rights to lapse, in which case you will receive no value for these rights.

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The value of your investment may be reduced by possible future sales of common shares or ADSs by us or our shareholders.

One or more of our existing shareholders may, from time to time, dispose of significant numbers of our common shares or ADSs. For example, the National Development Fund, one of our major shareholders, has sold our shares in the form of ADSs in several transactions since 1997. In May 2005, Philips, another major shareholder of ours, reiterated its intention, first announced in October 2003, to gradually and orderly reduce its equity interest in us.

On March 9, 2007, Philips and TSMC jointly announced a multi-phase plan to facilitate an orderly exit by Philips from its current shareholding in us. Specifically, according to the announced plan, Philips intends to divest its current shareholding in us through one or more block trades on the Taiwan Stock Exchange, a public offering of our common shares in the form of ADSs, and through participation in the share buy-backs conducted by us during a period beginning in 2007 and ending in 2010.

The plan's initial step occurred on March 12, 2007, when Philips sold approximately US\$1.75 billion worth of our common shares over the Taiwan Stock Exchange through block trades to a few institutional investors in Taiwan.

The plan's second step was a sale by Philips in a public offering registered with the U.S. Securities and Exchange Commission of approximately US\$2.56 billion worth of our common shares in the form of ADSs on May 18, 2007. It is the intention of TSMC and Philips that no further ADS offerings will be conducted in respect of Philips' shareholding in TSMC.

For the third step of the plan, we conducted a share repurchase program from November 14, 2007 to December 31, 2007, in the amount of approximately US\$1.5 billion, and subsequently canceled 800 million common shares that had been repurchased. During the same period, Philips also disposed 800 million of our common shares by selling them in the open market. After the completion of this third step, Philips held approximately 5.1% of our total outstanding common shares as of February 29, 2008.

Lastly, the plan's fourth step calls for us to conduct, subject to maintaining our current annual cash dividend per share, additional share repurchase and cancellation programs between 2008 and 2010. Philips has informed us that it intends to tender its remaining equity interest in us at such time. Philips may also consider selling its remaining equity interest in us to specified long-term investors mutually agreeable to Philips and us.

While we hope to continue to work with Philips to implement the above plan to facilitate the contemplated disposals by Philips of its equity interests in us in a way that, to the extent possible, minimizes any adverse impact on us and the market price of our ADSs and common shares, there is no written agreement between us and Philips in respect of the above plan and no assurances can be given as to the timing and potential impact of the implementation of such plan or any other method of disposal by Philips.

We cannot predict the effect, if any, that future sales of ADSs or common shares, or the availability of ADSs or common shares for future sale, will have on the market price of ADSs or common shares prevailing from time to time. Sales of substantial amounts of ADSs or common shares in the public market, or the perception that such sales may occur, could depress the prevailing market price of our ADSs or common shares.

The market value of our shares may fluctuate due to the volatility of, and government intervention in, the R.O.C. securities market.

Because the Taiwan Stock Exchange experiences from time to time substantial fluctuations in the prices and volumes of sales of listed securities, there are currently limits on the range of daily price movements on the Taiwan Stock Exchange. In response to past declines and volatility in the securities markets in Taiwan, and in line with similar activities by other countries in Asia, the government of the R.O.C. formed the Stabilization Fund, which has purchased and may from time to time purchase shares of Taiwan companies to support these markets. In addition, other funds associated with the R.O.C. government have in the past purchased, and may from time to time purchase, shares of Taiwan companies on the Taiwan Stock Exchange or other markets. In the future, market activity by government entities, or the perception that such activity is taking place, may take place or has ceased, may cause

fluctuations in the market prices of our ADSs and common shares.

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We believe we are currently the world's largest dedicated foundry in the semiconductor industry. We were founded in 1987 as a joint venture among the R.O.C. government, Philips and other private investors and were incorporated in the R.O.C. on February 21, 1987. Our common shares have been listed on the Taiwan Stock Exchange since September 5, 1994, and our ADSs have been listed on the New York Stock Exchange since October 8, 1997.

Vanguard International Semiconductor Corporation (VIS). In 1994, we, the R.O.C. Ministry of Economic Affairs and other investors established Vanguard, then an integrated DRAM manufacturer. Vanguard commenced volume commercial production in 1995 and listed its shares on the GreTai Securities Market in March 1999. As of February 29, 2008, we owned 36.7% of Vanguard. Please see Item 7. Major Shareholders and Related Party Transactions for a further discussion.

WaferTech in the United States. In 1996, we entered into a joint venture called WaferTech (of which the manufacturing entity is Fab 11) with several U.S.-based investors to construct and operate a US\$1.2 billion foundry in the United States. Initial trial production at WaferTech commenced in July 1998 and commercial production commenced in October 1998. In December 1998, we increased the percentage of our ownership interest in WaferTech to 68%. By the end of the first quarter of 2001, we had increased the percentage of our ownership interest in WaferTech to approximately 99% by purchasing all of the remaining interest of all of the other joint venture partners. As of February 29, 2008, we owned an approximately 99.996% equity interest in WaferTech.

Systems on Silicon Manufacturing Company Pte. Ltd. (SSMC). In March 1999, we entered into an agreement with Philips and EDB Investment Pte. Ltd. to found a joint venture, SSMC, to build a fab in Singapore. The SSMC fab commenced production in December 2000. Please see Item 7 Major Shareholders and Related Party Transactions for a further discussion.

Global Unichip Corporation (GUC). In January 2003, we acquired a 52.0% equity interest in GUC, a System-on-a-Chip (SoC) design service company that provides large scale SOC implementation services. GUC has been listed on Taiwan Stock Exchange since November 3, 2006. We owned 37.0% equity interest in GUC as of February 29, 2008.

Operations in Mainland China. In August 2003, we established TSMC Shanghai (of which the manufacturing entity is Fab 10), a wholly-owned subsidiary primarily engaged in the manufacturing and selling of integrated circuits. We have achieved commercial production with 0.35 micron, 0.25 micron and 0.18 micron process technologies in Fab 10, our 200mm wafer fab in Shanghai, where we commenced production in late 2004. As of February 29, 2008, we owned a 100% equity interest in TSMC Shanghai.

VisEra Technologies Company, Ltd. (VisEra). In October 2003, we and OmniVision Technologies Inc., entered into a shareholders' agreement to form VisEra Technologies Company, Ltd., a joint venture in Taiwan, for the purpose of providing back-end manufacturing service. As of February 29, 2008, we owned 44.1% equity interest in VisEra Technologies Company Ltd. Please see Item 7. Major Shareholders and Related Party Transactions for a further discussion.

Xintec, Inc. (Xintec). In January 2007, we acquired a 43.0% equity interest in XinTec, a supplier of wafer level packaging service, that we perceive would support our CMOS manufacturing business. As of February 29, 2008, we owned 42.5% equity interest in Xintec.

Beginning March 1, 2008, we re-structured our business unit organization by forming the new Advanced Technology Business Organization and Mainstream Technology Business Organization. These two new organizations will respectively take responsibility for formulation, development, and execution of advanced technology and mainstream technology business objectives.

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Our Principal Office

Our principal executive office is located at No. 8, Li-Hsin Road 6, Hsinchu Science Park, Hsinchu, Taiwan, Republic of China. Our telephone number at that office is (886-3) 563-6688. Our web site is www.tsmc.com. Information contained on our website does not constitute part of this annual report.

Business Overview of the Company

As a foundry, we manufacture semiconductors using our advanced or mainstream manufacturing processes for our customers based on their own or third parties' proprietary integrated circuit designs. We offer a comprehensive range of leading edge wafer fabrication processes, including processes to manufacture CMOS logic, mixed-signal, radio frequency, embedded memory, BiCMOS mixed-signal and other semiconductors. IC Insights (The McClean Report 2008 Edition) estimates that our revenue market share among dedicated foundries worldwide was 49% in 2006 and 47% in 2007. We also offer design, mask making, probing, testing and assembly services.

We believe that our large capacity, particularly for advanced technologies, is a major competitive advantage. Please see [Manufacturing Capacity and Technology](#) and [Capacity Expansion and Technology Upgrade Plans](#) for a further discussion of our capacity.

We count among our customers many of the world's leading semiconductor companies, ranging from fabless semiconductor and systems companies such as Altera Corporation, Broadcom Corporation, Marvell Semiconductor Inc., Microsoft Corporation, nVidia Corporation and Qualcomm Incorporated, to integrated device manufacturers such as Advanced Micro Devices, Inc., Analog Devices, Inc., Freescale Semiconductor Inc. and NXP Semiconductors. Fabless semiconductor and system companies accounted for approximately 67%, and integrated device manufacturers accounted for approximately 33%, of our net sales in 2007.

Our Facilities

After combining the operations at two of our 200mm fabs in 2001 and the decommissioning of one of our 150mm wafer fabs (Fab 1) in March 2002, we currently operate one 150mm wafer fab, six 200mm wafer fabs and two 300mm wafer fabs, including Fab 14, where we commenced production in the fourth quarter of 2004. Our corporate headquarters and five of our fabs are located in the Hsinchu Science Park, two fabs are located in the Tainan Science Park, one fab is located in the United States, and one fab is located in Shanghai. Our corporate headquarters and our five fabs in Hsinchu occupy approximately 417,168 square meters of land. We lease all of this land from the Hsinchu Science Park Administration in Hsinchu under agreements that will be up for renewal in December 2027. We have leased from the Southern Taiwan Science Park Development Office 395,000 square meters of land for our fabs in the Tainan Science Park under agreements that will be up for renewal between November 2018 and December 2025. WaferTech owns 1,052,181 square meters of land in the State of Washington in the United States, where the WaferTech fab and related offices are located. TSMC Shanghai owns 420,000 square meters of land in Shanghai, where Fab 10 and related offices are located.

Other than certain equipment under leases located at testing areas, we own all of the buildings and equipment for our fabs. We are expanding our 300mm fabrication capacity and R&D through Fab 12 in the Hsinchu Science Park and Fab 14 in the Tainan Science Park. Total monthly capacity for 300mm fabs was increased from 93,700 wafers in 2006 to 130,700 wafers in 2007. We will continuously evaluate our 300mm capacity in light of prevailing market conditions.

Manufacturing Capacity and Technology

We manufacture semiconductors on silicon wafers based on proprietary circuitry designs provided by our customers or third party designers. Two key factors that characterize a foundry's manufacturing capabilities are output capacity and fabrication process technologies. Since our establishment, we have possessed the largest capacity among the world's dedicated foundries. We also believe that we are the technology leader among the dedicated foundries in terms of our net sales of advanced semiconductors with a resolution of 0.13 micron and below, and are one of the leaders in the semiconductor industry generally. We are the first semiconductor foundry with proven low-k technology in commercial production from the 0.13 micron process technology down to 65-nanometer node. Following our commercial production based on 65-nanometer NexsysSM process technology in 2006, we also unveiled 55-nanometer NexsysSM process technology in 2007. Our 65-nanometer and 55-nanometer NexsysSM technologies are the third-generation proprietary processes that employ low-k dielectrics. In 2007, we also qualified our 45-nanometer

process technology with ultra low-k dielectrics and advanced immersion lithography. We expect to begin its commercial production in 2008.

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The following table lists our fabs and those of our affiliates, together with the year of commencement of commercial production, technology and capacity during the last five years:

Fab ⁽¹⁾	Year of commencement	Current most advanced technology for volume production ⁽²⁾	Monthly capacity ⁽³⁾⁽⁴⁾				
			2003	2004	2005	2006	2007
2	1990	0.45	42,977	47,584	47,584	50,506	51,685
3 ⁽⁵⁾	1995	0.18	71,600	83,300	83,300	89,900	90,500
5	1997	0.15	37,800	42,500	42,500	51,500	55,800
6	2000	0.13	63,500	73,000	73,000	83,400	94,000
7 ⁽⁷⁾	1995	0.35	11,800	13,400	13,400		
8	1998	0.15	63,500	76,500	76,500	83,500	89,400
10	2004	0.18		500	15,600	32,000	31,000
11	1998	0.15	30,000	32,500	33,500	35,500	35,500
12	2001	0.055	31,797	60,300	106,875	131,175	160,755
14	2004	0.055		6,750	46,125	79,650	133,279
SSMC ⁽⁶⁾	2000	0.18	9,600	13,400	16,700	17,700	20,700
Total			362,574	449,734	555,084	654,831	762,619

(1) Fab 2 produces 150mm wafers. Fabs 3, 5, 6, 8, 10, Fab 11 (WaferTech) and SSMC produce 200mm wafers. Fab 12 and Fab 14 produce 300mm wafers. Fabs 2, 3, 5, 8 and 12 are located in Hsinchu Science Park. Fab 6 and Fab 14 are located in the Tainan Science Park. WaferTech is located in the United States, SSMC is located in Singapore and Fab 10 is located in Shanghai.

(2) In microns, as of year-end.

- (3) Estimated capacity in 200mm equivalent wafers as of year-end for the total technology range available for production. Actual capacity during each year will be lower as new production capacity is phased in during the course of the year.
- (4) Under an agreement with Vanguard, TSMC is required to use its best commercial efforts to maintain utilization of a fixed amount of reserved capacity and will not increase or decrease the stipulated quantity by more than 5,000 wafers per month. Please see Item 7. Major Shareholders and Related Party Transaction Related Party Transactions Vanguard International Semiconductor Corporation for a discussion of certain of the Vanguard

contract terms.

The amounts to be used at Vanguard are not included in our monthly capacity figures.

- (5) Fab 4, which commenced operation in 1999 with initial technology of 0.5 micron, was consolidated into Fab 3 during the fourth quarter of 2001.
- (6) Represents that portion of the total capacity that we had the option to utilize as of December 31, 2003, December 31, 2004, December 31, 2005, December 31, 2006 and December 31, 2007. This fab commenced production in September 2000.
- (7) Fab 7 was decommissioned in June 2006 as we integrated its manufacturing facility as a part of Fab 12's operation.

As of December 31, 2007, our monthly capacity (in 200mm equivalent wafers) was 762,619 wafers, compared to 654,831 wafers at the end of 2006. This increase was primarily due to the expansion of our 0.15/0.18 micron mainstream technologies and our 90-nanometer and 65-nanometer advanced technologies.

Our semiconductor manufacturing facilities require substantial investment to construct and are largely fixed-cost assets once they are in operation. Because we own most of our manufacturing capacity, a significant portion of our operating costs is fixed. In general, these costs do not decline when customer demand or our capacity utilization rates drop, and thus declines in customer demand, among other factors, may significantly decrease our margins. Conversely, as product demand rises and factory utilization increases, the fixed costs are spread over increased output, which can improve our margins.

Except for regularly scheduled maintenance shutdowns, all of our fabs currently operate 24 hours per day, seven days per week. Employees work shifts of 12 hours each day on a two days on, two days off basis, except during periods of scheduled maintenance.

Capacity Expansion and Technology Upgrade Plans

We intend to maintain our strategy of expanding manufacturing capacity and improving manufacturing process technologies to meet both the fabrication and the technological needs of our customers. Based upon estimates of market demands, we currently expect to continue ramping up of Fab 12 and Fab 14 and capacity increases at Fab 10. The current capacity increase plan is based on our long term market demand forecast conducted periodically and may change significantly at any time.

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Our capital expenditures in 2005, 2006 and 2007 were NT\$79,879 million, NT\$78,737 million and NT\$84,001 million (US\$2,590 million), respectively. Our capital expenditures in 2008 are expected to be approximately US\$1,800 million, which may likely fluctuate depending on market conditions. In 2008, we anticipate capital expenditures to focus primarily on the following:

ramping up production at Fab 12 (Phase III), Fab 14 (Phase II) and Fab 10;

Fab 12 and Fab 14 facilities;

capacity expansion for mask and back-end operations; and

development of process technologies in 45-nanometer and below and other research and development projects.

These investment plans are still preliminary and our expected capital expenditures may change per market conditions.

Markets and Customers

The primary customers of our foundry services are fabless semiconductor companies/systems companies and integrated device manufacturers. The following table presents the breakdown of net sales by types of customers during the last three years:

Customer Type	Year ended December 31,					
	2005		2006		2007	
	Net Sales	Percentage	Net Sales	Percentage	Net Sales	Percentage
(in millions, except percentages)						
Fabless semiconductor companies/systems companies	NT\$187,662	70.4%	NT\$229,168	72.2%	NT\$215,662	66.8%
Integrated device manufacturers	78,903	29.6%	88,239	27.8%	106,968	33.2%
Total	NT\$266,565	100.0%	NT\$317,407	100.0%	NT\$322,630	100.0%

We categorize our net sales based on the country in which the customer is headquartered, which may be different from the net sales for the countries to which we actually sell or ship our products. Under this approach, the following table presents a regional geographic breakdown of our net sales during the last three years:

Region	Year ended December 31,					
	2005		2006		2007	
	Net Sales	Percentage	Net Sales	Percentage	Net Sales	Percentage
(in millions, except percentages)						
North America	NT\$205,255	77.0%	NT\$247,895	78.1%	NT\$247,832	76.8%
Asia	40,785	15.3%	43,167	13.6%	45,128	14.0%
Europe	20,525	7.7%	26,345	8.3%	29,670	9.2%
Total	NT\$266,565	100.0%	NT\$317,407	100.0%	NT\$322,630	100.0%

A significant portion of our net sales are attributable to a relatively small number of our customers. In 2006 and 2007, our ten largest customers accounted for approximately 53% and 51% of our net sales, respectively, and our largest customer accounted for approximately 10% and 11% of our net sales, respectively.

Over the years, we have attempted to strategically manage our exposure to commodity memory semiconductor manufacturing services. This policy has successfully shielded us from significant adverse effects resulting from the previous precipitous price drops in the commodity memory semiconductor market.

We have six customer support and/or marketing regions. The office in Hsinchu serves Asian (excluding Japanese and Mainland Chinese) customers. Wholly-owned subsidiaries in the United States, Japan, Mainland China, the Netherlands, South Korea and India serve North American, Japanese, Mainland Chinese, European, South Korean and

Indian customers, respectively. Foundry service sales are technologically intensive and involve frequent and intensive contacts with customers. We believe that the most effective means of marketing our foundry services is by developing direct relationships with our customers. We do not use agents or distributors. Our customer service managers work closely with the sales force by providing integrated services and detailed technical advice and specifications to customers.

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Commitments by Customers. Because of the fast-changing technology and functionality in semiconductor design, foundry customers generally do not place purchase orders far in advance to manufacture a particular type of product. However, we engage in discussions with customers regarding their expected manufacturing requirements in advance of the placement of purchase orders.

Several of our customers have entered into arrangements with us to ensure that they have access to specified capacity at our fabs. These arrangements are primarily in the form of deposit agreements. In a deposit agreement, the customer makes an advance cash deposit for an option on a specified capacity at our fabs. Deposits are generally refunded as shipments are made. As of December 31, 2007, our customers had on deposit an aggregate of approximately US\$68 million to reserve future capacity.

The Semiconductor Fabrication Process

The semiconductor manufacturing process begins with a thin silicon wafer on which an array of semiconductor devices is fabricated. The wafer is then tested, cut into chips, and assembled into packages that are then individually retested. Our focus is on wafer fabrication although we also provide all other services either directly or through outsourcing arrangements.

Our Foundry Services

Range of Services. Because of our ability to provide a full array of services, we are able to accommodate customers with a variety of input and output needs. The flexibility in input stages allows us to cater to a variety of customers with different in-house capabilities and thus to service a wider class of customers as compared to a foundry that cannot offer design or mask making services, for example.

Fabrication Processes. We manufacture semiconductors using the complementary metal oxide silicon, CMOS and BiCMOS processes. The CMOS process is currently the dominant semiconductor manufacturing process. The BiCMOS process combines the high speed of the bipolar circuitry and the low power consumption and high density of the CMOS circuitry. We use the CMOS process to manufacture logic semiconductors, memory semiconductors including SRAM, flash memory, mixed-signal/RF semiconductors, which combine analog and digital circuitry in a single semiconductor, and embedded memory semiconductors, which combine logic and memory in a single semiconductor. The BiCMOS process is used to make high-end mixed-signal and other types of semiconductors.

Types of Semiconductors We Manufacture. We manufacture different types of semiconductors with different specific functions by changing the number of and the combinations of conducting, insulating and semiconducting layers and by defining different patterns in which such layers are applied on the wafer. At any given point in time, there are over a hundred different products in various stages of fabrication at our foundries. We believe that the keys to maintaining high production quality and utilization rates are our effective management and control of the manufacturing process technologies that come from our extensive experience as the longest existing dedicated foundry and our dedication to quality control and process improvements.

The following is a general, non-exhaustive description of the key types of semiconductors that we currently manufacture. Depending on future market conditions, we may provide other services or manufacture other types of products that may differ significantly from the following:

Logic Semiconductors. Logic semiconductors process digital data to control the operation of electronic systems. The largest segment of the logic market, standard logic devices, includes microprocessors, microcontrollers, DSPs, graphic chips and chip sets.

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Mixed-Signal/RF Semiconductors. Analog/digital semiconductors combine analog and digital devices on a single semiconductor to process both analog and digital data. We make mixed-signal/RF semiconductors using both the CMOS and BiCMOS processes. We currently offer CMOS mixed-signal process down to the 45-nanometer NexsysSM technology for manufacturing mixed-signal/RF semiconductors. The primary uses of mixed-signal/RF semiconductors are in hard disk drives, wireless communications equipment and network communications equipment, with those made with the BiCMOS process occupying the higher end of the mixed-signal/RF market.

Memory Semiconductors. Memory semiconductors, which are used in electronic systems to store data and program instructions, are generally classified as either volatile memory (which lose their data content when power supplies are switched off) or nonvolatile memory (which retain their data content without the need for a constant power supply). We currently offer CMOS process for the manufacture of SRAM, embedded DRAM as volatile memory, and for the manufacture of flash memory and embedded flash as nonvolatile memory.

CMOS Image Sensor Semiconductors. Image sensors are primarily used in camera phone. We are currently the leading foundry for the production of CMOS image sensors, characterized by technology features including low dark current, high sensitivity, smaller pixel size and high dynamic range achieved through integration with mixed mode processes.

High Voltage Semiconductors. We currently offer a range of high-voltage processes including High Voltage CMOS (HVC MOS), Bipolar-CMOS-DMOS (BCD) and Ultra-high Voltage technology (UHV), ranging from 5V to 700V, which are suitable for various panel-size display driver and power IC applications.

The table below presents a breakdown of our net sales during the last three years by each semiconductor type:

Semiconductor Type	Year ended December 31,					
	2005		2006		2007	
	Net Sales	Percentage	Net Sales	Percentage	Net Sales	Percentage
(in millions, except percentages)						
CMOS						
Logic	NT\$199,657	74.9%	NT\$240,278	75.7%	NT\$234,354	72.6%
Memory	2,133	0.8%	3,174	1.0%	5,156	1.6%
Mixed-Signal ⁽¹⁾	63,442	23.8%	71,734	22.6%	80,247	24.9%
BiCMOS ⁽²⁾	1,066	0.4%	1,904	0.6%	2,517	0.8%
Others	267	0.1%	317	0.1%	356	0.1%
Total	NT\$266,565	100.0%	NT\$317,407	100.0%	NT\$322,630	100.0%

(1) Mixed-signal semiconductors made with the CMOS process.

(2) Mixed-signal and other semiconductors made with the BiCMOS process.

Design and Technology Platforms.

We offer a wide range of design services, from providing fundamental technology files, libraries and other silicon intellectual property to customization and chip implementation services.

To facilitate our customers' semiconductor designs, we provide a set of technology files for the process technologies we offer. The technology files include the necessary information to support design activities in physical layout, verification and circuit simulation. We can also provide complete process design kits, or PDKs, to support our

customers circuit design environment.

To accelerate the time-to-market for our customers, we provide a set of foundation library and selected silicon intellectual property to help designers expedite their design process. Our library and silicon intellectual property portfolio includes standard logic cells, input/output interface cells, and memory/analog blocks. Each library and silicon intellectual property portfolio is designed to maximize performance while minimizing area and power consumption. We also enter into arrangements with third-party providers to provide to our customers a broader range of library and silicon intellectual property offerings.

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With advanced process technologies predominately entering the nano-meter range, designers require more guidance to deal with the increasing complexities of managing performance and power consumption. Also, due to limited design and process margin on nano-meter technologies, fabless designers are required to work closely with a foundry to ensure that their designs are suitable for commercial manufacturing and can quickly be transferred to large volume manufacturing. For these purposes, we also provide design for manufacturing services, or DFM services, for our customers. We also create DFM models for advanced design flows that we co-developed with major design automation companies. Many of these advanced design flows are incorporated into our library, silicon intellectual property development and chip implementation services.

In 2006 and 2007, we also established three design centers in North America, which allowed us to recruit North American design talent to further enhance our capability on design enablement.

Multi-project Wafers Program (CyberShuttle). To help our customers reduce costs, we offer a dedicated multi-project wafer processing service that allows us to provide multiple customers with circuits produced with the same mask. This program reduces mask costs by a very significant factor, resulting in accelerated time-to-market for our customers. We have extended this program to all of our customers and library and IP partners using our broad selection of process technologies, ranging from the latest 40-, 45-, 55- and 65-nanometer processes to 0.18-, 0.25- and 0.35- micron. This extension offers a routinely scheduled multi-project wafer run to customers on a shared-cost basis for prototyping and verification.

We developed our multi-project wafer program in response to the current system-on-chip development methodologies, which often require the independent development, prototyping and validation of several IPs before they can be integrated onto a single device. By sharing mask cost among our customers to the extent permissible, the system-on-chip supplier can enjoy reduced prototyping costs and greater confidence that the design will be successful.

Customer Service

We believe that our focus on customer service has been an important factor in attracting leading semiconductor companies as customers. The key elements of our customer service are our:

firmly established customer-oriented culture, which emphasizes close interaction with our customers on a multifaceted basis, from senior management, sales and marketing, customer service staff to product and line engineers in the fabs and research and development staff;

ability to deliver ordered wafers of consistent quality, on time and in the desired quantities;

responsiveness to customer's requirements in terms of engineering change orders and special wafer handling;

flexibility in manufacturing processes, order size requirements and design changes, attributable in part to our technical capability and ability to plan and manage effectively many production runs;

ability to reduce customer costs through the sharing, to the extent permissible, of ever increasing silicon verification costs through our multi-project wafer service, which combines multiple designs on a single mask set;

eFoundry service which features real-time on-line information exchange throughout product design, engineering and logistic phases, including WIP (work in progress) performance reports for both in-house and subcontracted activities, for the processes of handling, assembly and final testing, before the products are shipped to our customers; and

Virtual fab , which is a customer service program designed to make our manufacturing services as transparent and easy to deal with for our customers as their own in-house fabs, with well coordinated resource management. The Virtual fab provides customers with the benefits of in-house fabs, including confidentiality of proprietary information, quality of service and products, on-time delivery and flexibility in scheduling and capacity.

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Research and Development

The semiconductor industry is characterized by rapid changes in technology, frequently resulting in the introduction of new technologies to meet customers' demands and in the obsolescence of recently introduced technology and products. We believe that, in order to stay technologically ahead of our competitors and maintain our market position in the foundry segment of the semiconductor industry, we need to maintain our position as a technology leader not only in the foundry segment but in the semiconductor industry in general. We spent NT\$14,017 million, NT\$16,076 million and NT\$17,946 million (US\$553 million) in 2005, 2006 and 2007, respectively, on research and development, which represented 5.3%, 5.1% and 5.5%, respectively, of our net sales for these periods. We plan to continue to invest significant amounts on research and development in 2008, with the goal of maintaining a leading position in the development of advanced process technologies. Our research and development efforts have recently allowed us to provide our customers access to certain advanced process technologies, such as 90-nanometer, 80-nanometer, 65-nanometer and 55-nanometer NexsysSM technology for volume production, prior to the implementation of those advanced process technologies by many integrated device manufacturers and our competitors. In addition, we expect to advance our process technologies further down to 45-nanometer and below in the coming years to maintain our technology leadership. We will also continue to invest in research and development for our mainstream technology offerings.

Our research and development efforts are divided into centralized research and development activities and research and development activities undertaken by each of our fabs. Our centralized research and development activities are principally directed toward developing most advanced and new generation manufacturing technologies. The research and development activities undertaken in each fab focus on upgrading the manufacturing process technologies.

We use internally developed process technologies and process technologies licensed from our customers and third parties. In continuing to advance our process technologies, we intend to rely primarily on our internal engineering capability and know-how and our research and development efforts, including collaboration with our customers, equipment vendors and R&D consortia.

We also continuously create in-house inventions and know-how. Since our inception, every year we apply for and are issued a substantial number of United States and other patents, most of which are semiconductor-related.

Equipment

The quality and technology of the equipment used in the semiconductor manufacturing process are important in that they effectively define the limits of our process technology. Advances in process technology cannot be brought about without commensurate advances in equipment technology. The principal pieces of equipment used by us to manufacture semiconductors are scanners, steppers, cleaners and track equipment, inspection equipment, etchers, furnaces, wet stations, strippers, implanters, sputterers, CVD equipment, testers and probers. Other than certain equipment under leases located at testing areas, we own all of the equipment used at our fabs.

In implementing our capacity expansion and technology advancement plans, we expect to make significant purchases of equipment required for semiconductor manufacturing. Some of the equipment is available from a limited number of vendors and/or is manufactured in relatively limited quantities, and certain equipment has only recently been developed. We believe that our relationships with our equipment suppliers are good and that we have enjoyed the advantages of being a major purchaser of semiconductor fabrication equipment. We work closely with manufacturers to provide equipment customized to our needs for certain advanced technologies.

Raw Materials

Our manufacturing processes use many raw materials, primarily silicon wafers, chemicals, gases and various types of precious and other metals. Raw materials costs constituted 12.6% of our net sales in 2006 and 13.9% of our net sales in 2007. Most of our raw materials generally are available from several suppliers. Our raw material procurement policy is to select only those vendors who have demonstrated quality control and reliability on delivery time and to maintain multiple sources for each raw material so that a quality or delivery problem with any one vendor will not adversely affect our operations. The quality and delivery performance of each vendor is evaluated monthly or quarterly and quantity allocations are adjusted for subsequent periods based on the evaluation.

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The most important raw material used in our production is silicon wafers, which is the basic raw material from which integrated circuits are made. The principal suppliers for our wafers are Shin-Etsu Handotai and SUMCO Corporation of Japan, Siltronic AG of Germany, MEMC Electronic Materials, Inc. of the United States, and Formosa SUMCO Technology of Taiwan. Together they supplied approximately 89.6% and 91.6% of our total wafer needs in 2006 and 2007, respectively. We have in the past obtained, and believe we will continue to be able to obtain, a sufficient supply of 150mm, 200mm and 300mm wafers. However, surge demand for some specialty products that require use of specialty wafers may sometimes cause a sudden shortage of the supply of specialty wafers. The price of wafers decreased slightly during 2006 and 2007. We expect wafer prices to continue to decrease in 2008.

In order to secure a reliable and flexible supply of high quality wafers, we entered into long-term agreements and intend to develop strategic relationships with major wafer vendors to cover our anticipated wafer needs for the next three to five years. Also, we have a special cross-function taskforce comprised of individuals from our fab operations, materials management, risk management and quality system management divisions to improve our supply chain risk management. This taskforce works with our primary suppliers to qualify their dual-plant materials, prepare safety inventories, improve the quality of their products and implement supply chain risk management.

Competition

We compete internationally and domestically with dedicated foundry service providers, as well as with integrated device manufacturers that devote a significant portion of their manufacturing capacity to foundry operations. We compete primarily on the basis of process technology, quality and service. The level of competition differs according to the process technology involved. For example, in more mature technologies, the competition tends to be more intense. Some companies compete with us in selected geographic regions or application end markets. In recent years, substantial investments have been made by others to establish new dedicated foundry companies in mainland China and elsewhere.

Environmental Regulation

The semiconductor production process generates gaseous chemical wastes, liquid wastes, waste water and other industrial wastes in various stages of the manufacturing process. We have installed various types of pollution control equipment for the treatment of gaseous chemical wastes and liquid wastes and equipment for the recycling of treated water in our fabs. Our operations at our fabs are subject to regulation and periodic monitoring by the R.O.C. Environmental Protection Administration, U.S. Environmental Protection Agency or State Environmental Protection Administration of mainland China, and local environmental protection authorities, including the Science Park Administration, the Washington State Department of Ecology or the Shanghai Environmental Protection Bureau.

We have adopted pollution control measures which are expected to result in the effective maintenance of environmental protection standards consistent with the practice of the semiconductor industry in Taiwan, the U.S. and mainland China. We conduct an annual environmental audit to ensure that we are in compliance in all material respects with, and we believe that we are in compliance in all material respects with, applicable environmental laws and regulations. Our waste reduction steps also comply with Taiwan regulatory requirements.

We received ISO14001 certification in August 1996 and QC 080000 IECQ HSPM, a certification for having a hazardous substance process management system that meets the European environmental regulation RoHS (Restriction of Hazardous Substance) Directive, in July 2006. We have continued to implement improvement programs in connection with these certifications. For example, all of our manufacturing sites in Taiwan were ISO14001 certified in 2005 and QC 080000 certified in 2007. Fab 10, our manufacturing site in mainland China, also received ISO 14001 certification in 2005 and QC 080000 certification in 2007. In addition, WaferTech obtained ISO 14001 certification in 2001 and QC 080000 certification in 2006. In 2007, we received the Energy Conservation Award and Excellence in Voluntary Greenhouse Gases Emission Reduction Award from the Ministry of Economic Affairs, Executive Yuan, R.O.C., the National Award for Outstanding Achievements in Industrial Waste Disposal and Resources and Recycling from the Environmental Protection Administration, Executive Yuan, R.O.C. and Water Conservation Outstanding Performance Award from the Water Resource Agency, Ministry of Economic Affairs, Executive Yuan, R.O.C. WaferTech has also been a member of the U.S. Environmental Protection Agency's Performance Track Program since 2004.

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In 2001, we have expressed our voluntary commitment to reducing perfluorinated compounds (PFCs) emissions to 10% below the average emission value of 1997 and 1999 by 2010, based on the standard set forth in a Memorandum of Understanding by the Taiwan Semiconductor Industrial Association. In our effort to achieve such commitment, the evaluation and implementation of projects including process optimization, chemical replacement and abatement systems have been commenced by us.

Electricity and Water

We use electricity supplied by Taiwan Power Company in our manufacturing process. Businesses in the Hsinchu Science Park and Tainan Science Park, such as ours, enjoy preferential electricity supply. We have sometimes suffered power outages caused by our electricity supplier, the Taiwan Power Company, which lead to interruptions in our production schedule. The semiconductor manufacturing processes also use extensive amounts of fresh water. Due to the growth of the semiconductor manufacturers in the Hsinchu Science Park and Tainan Science Park, and the droughts that Taiwan experiences from time to time, there is concern regarding future availability of sufficient fresh water and the potential impact insufficient water supplies may have on our semiconductor production.

Risk Management

We employ an enterprise risk management system to integrate the prevention and control of TSMC and our subsidiaries' risks. We have also prepared emergency plans to respond to natural disaster and other disruptive events that could disrupt the operation of our business. These emergency plans are developed to prevent or minimize loss of personnel and damage to our facilities, equipment and machinery caused by natural disaster and other disruptive events. We also maintain insurance with respect to our facilities, equipment and inventories. The insurance for the fabs and their equipment covers, subject to some limitations, various risks including fire, typhoon, earthquake and some other risks generally up to the respective policy limits for their replacement values and lost profits due to business interruption. In addition, we have insurance policies covering losses in respect of the construction and erection of all our fabs. Equipment and inventories in transit are also insured.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

ITEM 5. OPERATING AND FINANCIAL REVIEWS AND PROSPECTS

Overview

We manufacture a variety of semiconductors based on designs provided by our customers. We also provide various design services. Our business model is now commonly called a dedicated semiconductor foundry. The foundry segment of the semiconductor industry as a whole experienced rapid growth over the last 20 years since our inception. As the leader of the foundry segment of the semiconductor industry, our net sales and net income increased from NT\$266,565 million and NT\$93,575 million in 2005 to NT\$317,407 million and NT\$127,010 million in 2006 and NT\$322,630 million (US\$9,948 million) and NT\$109,177 million (US\$3,367 million) in 2007, respectively. Our sales increase in 2006 and 2007 were primarily the result of a continued growth in the semiconductor industry and customer demand, offset in part by the declines in average selling price resulting principally from pricing pressures in our customers' end markets and an increase in competition.

The principal source of our revenue is wafer fabrication, which accounted for approximately 91% of our net sales in 2007. The rest of our net sales is derived from design, mask making, probing, and testing and assembly services. Factors that significantly impact our revenue include:

the worldwide demand for semiconductor products;

pricing;

the worldwide semiconductor production capacity as well as our production capacity;

capacity utilization;

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technology migration; and

fluctuation in foreign currency exchange rate.

Substantial Fixed Costs for Production Capacity. Our semiconductor manufacturing facilities require substantial investment to construct and are largely fixed-cost assets once they are in operation. Because we own most of our manufacturing capacity, a significant portion of our operating costs are fixed. In general, these costs do not decline when customer demand or our capacity utilization rates drop, and thus declines in customer demand, among other factors, may significantly decrease our margins. Conversely, as product demand rises and factory utilization increases, the fixed costs are spread over increased output, which can improve our margins. We have expanded our aggregate capacity from 555,084 200mm equivalent wafers per month as of year-end 2005 to 762,619 200mm equivalent wafers per month as of year-end 2007. Our annual sales volume grew from approximately 5,622,000 200mm equivalent wafers in 2005 to approximately 8,005,000 200mm equivalent wafers in 2007. In 2007, while our operations in the first quarter ran at a level significantly below the average for the year as a result of our customers' inventory correction, our capacity utilization rate started to rise from the second quarter and increased further in the last quarter, due to the recovery of customer demand.

Technology Migration.

The table below presents a percentage breakdown of wafer sales by circuit resolution during the last three years:

Resolution	Year ended December 31,		
	2005 Percentage of total wafer revenue ⁽¹⁾	2006 Percentage of total wafer revenue ⁽¹⁾	2007 Percentage of total wafer revenue ⁽¹⁾
£65 nanometer			6%
90 nanometer	9%	23%	26%
0.13 micron	36%	26%	23%
0.15 micron	9%	10%	9%
0.18 micron	24%	22%	20%
0.25 micron	10%	8%	7%
0.35 micron	6%	6%	5%
≥0.5 micron	6%	5%	4%
Total	100%	100%	100%

(1) Percentages represent wafer revenue by technology as a percentage of total revenue from wafer sales, which exclude revenue not associated with wafer sales, such as revenue from testing and

masks. Total
wafer revenue
excludes sales
returns and
allowances.

Pricing. We usually establish pricing levels for a specific period with our customers, subject to adjustment during the course of that period to take into account market developments and other factors. We believe that our large capacity, flexible manufacturing capabilities, focus on customer service and ability to deliver high yields in a predictable and timely manner have contributed to our ability to obtain premium pricing for our wafer production. Our historical pricing policy is to pass through to our customers a portion of cost savings realized as our production processes migrate to more advanced technologies and our manufacturing operations achieve higher yields and greater economy of scale.

Critical Accounting Policies

Summarized below are our accounting policies that we believe are both important to the portrayal of our financial results and involve the need for management to make estimates about the effect of matters that are uncertain in nature. Actual results may differ from these estimates, judgments and assumptions. Certain accounting policies are particularly critical because of their significance to our reported financial results and the possibility that future events may differ significantly from the conditions and assumptions underlying the estimates used and judgments made by our management in preparing our financial statements. The following discussion should be read in conjunction with the consolidated financial statements and related notes, which are included in this annual report.

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Revenue recognition. We recognize revenue when evidence of an arrangement exists, the rewards of ownership and significant risk of the goods have been transferred to the buyer, price is fixed or determinable, and the collectibility is reasonably assured. We record a provision for estimated future returns and other allowances in the same period the related revenue is recorded. Provision for estimated sales returns and other allowances is generally made and adjusted at a specific percentage based on historical experience, our management's judgment, and any known factors that would significantly affect the allowance, and our management periodically reviews the adequacy of the percentage used. However, because of the inherent nature of estimates, actual returns and allowances could be different from our estimates. If the actual returns are greater than our estimated amount, we could be required to record an additional provision, which would have a negative impact on our recorded revenue and gross margin.

As of December 31, 2005, 2006 and 2007, the amount set aside for sales returns and allowances recorded in the accompanying consolidated statements of income was NT\$5,806 million, NT\$5,382 million and NT\$5,773 million (US\$178 million), respectively, representing 2.1%, 1.7% and 1.8% of our gross sales for the years ended December 31, 2005, 2006 and 2007. In 2005 and 2006, no additional provisions were recorded subsequent to the year-end. Subsequent to December 31, 2007, we also did not have to record any additional provisions for 2007, as of February 29, 2008.

Allowances for doubtful accounts. We record provisions for doubtful accounts based on a percentage of accounts receivables due from our customers. We determine this percentage by examining our historical collection experience and current trends in the credit quality of our customers as well as our internal credit policies. If the financial condition of our customers, or economic conditions in general, were to deteriorate, additional allowances may be required in the future and such additional allowances would increase our operating expenses and therefore reduce our operating income and net income.

As of December 31, 2005, 2006 and 2007, the allowance set aside for doubtful receivables was NT\$981 million, NT\$750 million and NT\$702 million (US\$22 million), respectively, representing 2.2%, 2.1% and 1.5% of our gross notes and accounts receivables as of those dates. For the years ended December 31, 2005 and 2006, we did not have to record any additional allowances subsequent to year-end. Subsequent to December 31, 2007, we also did not have to record any additional allowances for 2007 as of February 29, 2008.

Inventory valuation. Inventories are stated at the lower of cost or market value. Market value represents the net realizable value for finished goods and work-in-progress, and replacement costs for raw materials, supplies and spare parts. Due to rapid technology changes, we also evaluate our ending inventory and reduce the carrying value of inventory for estimated obsolescence and unmarketable inventory by an amount that is the difference between the cost of the inventory and the lower estimated market value. The estimated market value of the inventory is mainly determined based on assumptions of future demand within a specific time horizon, which is generally 180 days or less. If actual demand and market conditions are less favorable than those projected by management, additional write-downs may be required. If actual demand and market conditions are more favorable than anticipated, inventory previously written down may be sold at a higher price, resulting in lower cost of sales and higher income from operations than expected in that period.

As of December 31, 2005, 2006 and 2007, we recorded inventory valuation allowances in the aggregate amount of NT\$1,686 million, NT\$1,005 million and NT\$931 million (US\$29 million), respectively. Our inventory valuation allowances were primarily for estimated scraps and defects. For the years ended December 31, 2005 and 2006, we did not have to record any additional allowances subsequent to year-end. Subsequent to December 31, 2007, we also did not have to record any additional allowances for 2007 as of February 29, 2008.

Valuation allowance for deferred tax assets. When we have net operating loss carry forwards, investment tax credits or temporary differences in the amount of tax recorded for tax purposes and accounting purposes, we may be able to reduce the amount of tax that we would otherwise be required to pay in future periods. We recognize all existing future tax benefits arising from these tax attributes as deferred tax assets and then establish a valuation allowance equal to the extent, if any, that it is more likely than not that deferred tax assets will not be realized. We record an income tax benefit or expense when there is a net change in our total deferred tax assets and liabilities in a period. The ultimate realization of the deferred tax assets depends upon the generation of future taxable income during the periods in which the net operating losses and temporary differences become deductible or the investment tax

credits may be utilized. Specifically, our valuation allowances are impacted by our expected future revenue growth and profitability, tax holidays, alternative minimum tax, and the amount of tax credits that can be utilized within the statutory period. In determining the amount of valuation allowance for deferred tax assets as of December 31, 2007, we considered past performance, the general outlook of the semiconductor industry, future taxable income and prudent and feasible tax planning strategies.

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Because the determination of the amount of valuation allowance is based, in part, on our forecast of future profitability, it is inherently uncertain and subjective. Changes in market conditions and our assumptions may cause the actual future profitability to differ materially from our current expectation, which may require us to increase or decrease the amount of valuation allowance that we have recorded. Because our expectation for future profitability is generally less during periods of reduced revenue, we will be more likely to provide significant valuation allowances with respect to deferred tax assets during those periods of already reduced income.

As of December 31, 2005, 2006 and 2007, the ending balance for valuation allowances under R.O.C. GAAP were NT\$11,191 million, NT\$8,127 million and NT\$4,162 million (US\$128 million), respectively, representing 44.5%, 37.0% and 24.4% of net deferred tax assets as of those dates.

Valuation of long-lived assets and intangible assets. We assess the impairment of long-lived assets and intangible assets whenever triggering events or changes in circumstances indicate that the asset may be impaired and carrying value may not be recoverable. Our long-lived assets subject to this evaluation include property, plant and equipment and amortizable intangible assets. Factors we consider important which could trigger an impairment review include, but are not limited to, the following:

significant under performance relative to historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or our overall business strategy; and

significant unfavorable industry or economic trends.

When we determine that the carrying value of intangible assets and other long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment for long-lived assets based on a projected future cash flow. If the long-lived or intangible assets that are determined to be impaired are to be held and used, we recognize an impairment loss through a charge to our operating results to the extent the present value of discounted cash flows attributable to the assets are less than their carrying value. We also perform periodic review to identify the assets that are no longer used and are not expected to be used in future periods. An impairment charge is recorded to the extent, if any, that the carrying amount of the idle assets exceeds their fair value. Under R.O.C. GAAP, if the recoverable amount increases in a future period, the amount previously recognized as impairment will be reversed and recognized as a gain. However, the adjusted amount may not exceed the carrying amount that would have been determined, net of depreciation, as if no impairment loss had been recognized.

The process of evaluating the potential impairment of long-lived assets requires significant judgment. We are required to review for impairment groups of assets related to the lowest level of identifiable independent cash flows. Due to our asset usage model and the interchangeable nature of our semiconductor manufacturing capacity, we must make subjective judgments in determining the independent cash flows that can be related to specific asset groups. In addition, because we must make subjective judgments regarding the remaining useful lives of assets and the expected future revenue and expenses associated with the assets, changes in these estimates based on changed economic conditions or business strategies could result in material impairment charges in future periods. Our projection for future cash flow is generally less during periods of reduced earnings. As a result, an impairment charge is more likely to occur during a period when our operating results are already otherwise depressed.

Under R.O.C. GAAP, for purposes of evaluating the recoverability of long-lived assets, assets purchased for use in the business but subsequently determined to have no future economic benefits are written down to their fair value and recorded as either idle assets or assets held for disposition. However, prior to 2005, R.O.C. GAAP did not provide guidelines for impairment of assets that could still be used in the business. Therefore prior to 2005, long-lived assets that could still be used in the business and were impaired under U.S. GAAP continued to be depreciated for R.O.C. GAAP purposes. In 2000, WaferTech recorded approximately US\$330 million as impairment under U.S. GAAP. No additional impairment was recorded since then, as the value determined based on discounted cash flow or comparable market prices is higher than the carrying value of the long-lived assets.

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As of December 31, 2006 and 2007, net long-lived assets and intangible assets amounted to NT\$260,031 million and NT\$268,176 million (US\$8,269 million), respectively, under R.O.C. GAAP.

Goodwill. Goodwill is recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Under U.S. GAAP, and effective on January 1, 2005 under R.O.C. GAAP, we assess the impairment of goodwill on an annual basis, or more frequently whenever triggering events or changes in circumstances indicate that goodwill may be impaired and carrying value may not be recoverable. Moreover, effective on January 1, 2006, goodwill is no longer amortizable under R.O.C. GAAP. Factors we consider important which could trigger an impairment review include, without limitation, the following:

significant decline in our stock price for a sustained period; and

significant decline in our market capitalization relative to net book value.

Application of the goodwill impairment test is also highly subjective and requires significant judgment, including the identification of cash generating units, assigning assets and liabilities to the relevant cash generating units, assigning goodwill to the relevant cash generating units, and determining the fair value of the relevant cash generating units. Under R.O.C. GAAP, the fair value of the cash generating units is compared to the associated carrying value including goodwill. On the other hand, under U.S. GAAP, the fair value of the reporting units is compared to the associated carrying value including goodwill.

Under R.O.C. GAAP, goodwill recorded from the acquisition of TSMC-Acer and WaferTech is evaluated for impairment on an annual basis. Based on our most recent evaluation, the fair value calculated by using projected cash flow in five years was higher than the associated carrying value. As a result, we did not record any impairment charge under R.O.C. GAAP. Under U.S. GAAP, goodwill recorded from the acquisition of TSMC-Acer and WaferTech is evaluated for impairment on an annual basis. Based on our most recent evaluation, the fair value calculated by using the market capitalization method was higher than the associated carrying value. As a result, we also did not record any impairment charge, under U.S. GAAP.

As of December 31, 2006 and 2007, goodwill amounted to NT\$5,985 million and NT\$5,988 million (US\$185 million), respectively, under R.O.C. GAAP.

Accounting for investments in private and publicly-traded securities. We hold equity interests in companies, some of which are publicly traded and have highly volatile share prices. We review all of our investments for impairment quarterly and record an impairment charge when we believe an investment has experienced an other-than-temporary decline in value. Determining whether an other-than-temporary decline in value of the investment has occurred is highly subjective. Such evaluation is dependent on the specific facts and circumstances. Factors we consider include, but are not limited to, the following: the market value of the security in relation to its cost basis, the duration of the decline in value, the financial condition of the investees, and our intent and ability to retain the investment for a sufficient period of time to allow for recovery in the market value of the investment. Impairment reviews with respect to private equity investments also require significant judgments. Factors indicative of an other-than-temporary decline in value include recurring operating losses, credit defaults and subsequent rounds of financings at valuation below the cost basis of the investment.

We have experienced declines in the value of certain privately held investments and recorded impairment loss of NT\$129 million, NT\$280 million and NT\$54 million (US\$2 million) in 2005, 2006 and 2007, respectively. While we have recognized all declines that are currently believed to be other-than-temporary as a charge to income, adverse changes in market conditions or poor operating results of underlying investments could result in further losses in future periods.

Results of Operations

The following table sets forth, for the periods indicated, certain financial data from our consolidated statements of income, expressed in each case as a percentage of net sales:

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	For the year ended December 31,		
	2005	2006	2007
Net sales	100.0%	100.0%	100.0%
Cost of sales	(55.7)%	(50.9)%	(55.9)%
Gross profit	44.3%	49.1%	44.1%
Operating expenses			
General and administrative	(3.4)%	(2.7)%	(2.8)%
Sales and marketing	(1.6)%	(1.2)%	(1.2)%
Research and development	(5.3)%	(5.1)%	(5.5)%
Total operating expenses	(10.3)%	(9.0)%	(9.5)%
Income from operations	34.0%	40.1%	34.6%
Non-operating income and gains	3.5%	3.0%	3.7%
Non-operating expenses and losses	(2.2)%	(1.1)%	(0.6)%
Income before income tax and minority interest	35.3%	42.0%	37.7%
Income tax benefit (expense)	(0.2)%	(2.4)%	(3.6)%
Income before cumulative effect of changes in accounting principles	35.1%	39.6%	34.1%
Cumulative effect of changes in accounting principles		0.5%	
Income before minority interest	35.1%	40.1%	34.1%
Minority interest in loss (income) of subsidiaries	0.0%	(0.1)%	(0.3)%
Net income	35.1%	40.0%	33.8%

Year to Year Comparisons*Net Sales and Gross Margin*

	For the Year Ended December 31,					
			%			%
	2005	2006	Change from 2005	2007		Change from 2006
	NT\$	NT\$		NT\$	US\$	
	(in millions)			(in millions)		
Net sales	266,565	317,407	19.1%	322,630	9,948	1.6%
Cost of sales	(148,362)	(161,597)	8.9%	(180,280)	(5,559)	11.6%
Gross profit	118,203	155,810	31.8%	142,350	4,389	(8.6)%
Gross margin percentage	44.3%	49.1%		44.1%	44.1%	

Net Sales

Our net sales in 2007 increased by 1.6% from 2006. The increase in our net sales in 2007 was largely attributable to a continued increase in customer demand, which resulted in a 10.9% increase in wafer shipment in 2007, from 7,215 thousand 200mm equivalent wafers in 2006 to 8,005 thousand 200mm equivalent wafers in 2007. The increase in sales volume was partially offset by a 11.5% decrease in the average selling price of our wafers in U.S. dollar terms in 2007. The decrease in the average selling price of our wafers in U.S. dollar terms was primarily the result of a decline in pricing for the same product or technology resulting primarily from pricing pressures in customers' end market and an increase in competition, partially offset by a more favorable product mix as we saw a continued shift toward higher priced products using more advanced technologies. Our net sales in 2007 were also positively impacted

by the fact that the average exchange rate for the NT dollar against the U.S. dollar depreciated by 1.0% in 2007 compared to 2006, as a significant portion of our sales are denominated in U.S. dollars.

Our net sales in 2006 increased by 19.1% from 2005. The increase in our net sales in 2006 was largely attributable to a continued increase in customer demand, which resulted in a 28.3% increase in wafer shipment in 2006, from 5,622 thousand 200mm equivalent wafers in 2005 to 7,215 thousand 200mm equivalent wafers in 2006. The increase in sales volume was partially offset by a 7.4% decrease in the average selling price of our wafers in U.S. dollar terms in 2006. The decrease in the average selling price of our wafers in U.S. dollar terms was primarily the result of a decline in pricing for the same product or technology resulting primarily from pricing pressures in customers' end market and an increase in competition, partially offset by a more favorable product mix as we saw a continued shift toward higher priced products using more advanced technologies. Our net sales in 2006 were also positively impacted by the fact that the average exchange rate for the NT dollar against the U.S. dollar depreciated by 1.1% in 2006 compared to 2005, as a significant portion of our sales are denominated in U.S. dollars.

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Table of Contents*Gross Margin*

Our gross margin fluctuates, depending on the level of capacity utilization, wafer shipments, price change and product mix, among other factors. Our gross margin decreased to 44.1% of net sales in 2007 from 49.1% of net sales in 2006. The lower margin in 2007 was primarily driven by price declines, resulting primarily from pricing pressure in customers' end market and an increase in competition, which negatively impacted the gross margin by 6.1 percentage points. In addition, lower capacity utilization, which made 3.7 percentage points decrease in the gross margin, offset in part the favorable impact on gross margin of higher wafer shipments, the improvement in overall product mix, favorable cost reduction, which contributed 4.2 percentage points to the increase in gross margin, and a weaker average exchange rate of the NT dollar against the U.S. dollar, which contributed 0.6 percentage points to the increase in the gross margin. Depreciation and amortization expenses in cost of sales increased from NT\$69,123 million in 2006 to NT\$74,921 million (US\$2,310 million) in 2007. The increase in depreciation and amortization expenses in 2007 reflected the increase in depreciation from our advanced technology fabs, partially offset by the benefits received from the reduced depreciation of facilities and equipment in 200mm fabs, and lower amortization of deferred charges. We anticipate our depreciation and amortization expenses in cost of sales to increase in 2008, as we continue to ramp up capacity at Fab 12 and Fab 14, which will be partially offset by the benefits from the reduced depreciation of our 200mm fabs. In 2007, while our operations in the first quarter ran at a level significantly below the average for the year, our capacity utilization rate started to rise from the second quarter and increased further in the last quarter, due to the recovery of customer demand.

Our gross margin increased to 49.1% of net sales in 2006 from 44.3% of net sales in 2005. The higher margin in 2006 was primarily driven by higher capacity utilization, resulting primarily from higher market demands in 2006, which contributed 3.8 percentage points to the 4.8 percentage points increase in the gross margin. In addition, higher wafer shipments, the improvement in overall product mix, favorable cost reduction, which contributed 7.2 percentage points to the increase in the gross margin, and a weaker average exchange rate of the NT dollar against the U.S. dollar, which contributed 0.9 percentage points to the increase in the gross margin, more than offset the unfavorable impact on gross margin of price declines, which negatively impacted the gross margin by 7.1 percentage points. Depreciation and amortization expenses in cost of sales decreased marginally from NT\$69,902 million in 2005 to NT\$69,123 million (US\$2,121 million) in 2006. The decrease in depreciation and amortization expenses in 2006 reflected the benefits from the reduced depreciation of facilities and equipment in 200mm fabs, and lower amortization of deferred charges, partially offset by the increase in depreciation from our advanced technology fabs. In addition, while our operations ran on average at full capacity in 2006, after reaching a peak in the second quarter of 2006, our capacity utilization rate started to decline and decreased further in the last quarter of 2006 to a level significantly below full capacity due to a decrease in orders resulting from our customers' inventory correction and the demand weakness in the consumer, consumption and computer sectors.

Operating Expenses

	For the Year Ended December 31					
	2005	2006	% Change from 2005	2007		% Change from 2006
	NT\$ (in millions)	NT\$		NT\$ (in millions)	US\$	
Research and development	14,017	16,076	14.7%	17,946	553	11.6%
General and administrative	9,085	8,717	(4.1)%	8,964	276	2.8%
Sales and marketing	4,132	3,752	(9.2)%	3,718	115	(0.9)%
	27,234	28,545	4.8%	30,628	944	7.3%

Total operating expenses

Percentage of net sales	10.3%	9.0%		9.5%	9.5%	
Income from operations	90,969	127,265	39.9%	111,722	3,445	(12.2)%
Operating Margin	34.0%	40.1%		34.6%	34.6%	

Operating expenses increased by NT\$2,083 million in 2007, or 7.3%, from 2006, after an increase in operating expenses of NT\$1,311 million in 2006, or 4.8%, from 2005.

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Table of Contents*Research and Development Expenses*

We remain committed to being the leader in developing advanced process technology. We believe that continued investments in process technologies are essential for us to remain competitive in the markets we serve. Research and development expenditures increased by NT\$1,870 million in 2007, or 11.6%, from 2006. Research and development expenses were higher in 2007 than in 2006 primarily due to the increase in expenses relating to an increase in development activities in 32/45 nanometer technologies in 2007 as compared to 2006. We plan to continue to invest significant amounts in research and development expenses in 2008.

Research and development expenditures increased by NT\$2,059 million in 2006, or 14.7%, from 2005. Research and development expenses were higher in 2006 than in 2005 primarily due to the increase in expenses relating to an increase in development activities in 45/65 nanometer technologies in 2006 as compared to 2005.

General and Administrative, Sales and Marketing Expenses

General and administrative, sales and marketing expenses increased by NT\$213 million in 2007, or 1.7%, from 2006, due to an increase of general and administrative expenses by NT\$247 million, or 2.8%, and a decrease in sales and marketing expenses by NT\$34 million, or 0.9%. The increase in general and administrative expenses was primarily due to higher legal fees, partially offset by lower depreciation and amortization expenses. The decrease in sales and marketing expenses was primarily due to a reversal of 2006 accrued expense in 2007, partially offset by an increase in labor cost due to an increase in headcounts. The operating margin in 2007 was 34.6%, lower than 40.1% in 2006.

General and administrative, sales and marketing expenses decreased by NT\$748 million in 2006, or 5.7%, from 2005, due to a decrease of general and administrative expenses by NT\$368 million, or 4.1%, and a decrease in sales and marketing expenses by NT\$380 million, or 9.2%. The decrease in general and administrative expenses was primarily due to a change in accounting principle pursuant to which, effective January 1, 2006, goodwill was no longer amortizable under R.O.C. GAAP, partially offset by an increase in Fab 14 (phase II) opening expenses. With the commencement of its commercial operation in 2006, expenses associated with the start-up of Fab 14 (Phase II) ceased to be accounted for as general and administrative expenses going forward. The decrease in sales and marketing expenses was primarily due to a decrease in stock compensation and bonus expenses in 2006. The operating margin in 2006 was 40.1%, higher than 34.0% in 2005.

Non-Operating Income and Expenses

	For the Year Ended December 31					
	2005 ⁽¹⁾	2006 ⁽¹⁾	% Change	2007		% Change
	NT\$	NT\$	from 2005	NT\$	US\$	from 2006
	(in millions)			(in millions)		
Non-operating income and gains	9,399	9,705	3.3%	11,934	368	23.0%
Non-operating expenses and losses	(6,105)	(3,608)	(40.9)%	(2,014)	(62)	(44.2)%
Net non-operating income (expenses)	3,294	6,097	85.1%	9,920	306	62.7%

(1) As a result of the adoption of the newly released R.O.C. SFAS No. 34 and R.O.C. SFAS No. 36, the

amounts for the fiscal year ended December 31, 2005 were reclassified for comparison purposes. Such reclassifications resulted in a change of non-operating income and gains from NT\$7,068 million to NT\$9,399 million for the year ended December 31, 2005, and in a change of non-operating expenses and losses from NT\$3,773 million to NT\$6,105 million for the year ended December 31, 2005. See note 4 to our consolidated financial statements for additional details about these new accounting standards.

Net non-operating income increased by NT\$3,823 million in 2007, or 62.7%, from NT\$6,097 million in 2006 primarily due to a change from NT\$799 million net loss on settlement and disposal of financial instruments in 2006 to NT\$633 million net gain on settlement and disposal of financial instruments in 2007, a change from NT\$813 million net valuation loss on financial instruments in 2006 to NT\$305 million net valuation gain on financial instruments in 2007, a NT\$1,110 million increase in interest income, a change from NT\$401 million net foreign exchange loss in 2006 to a net foreign exchange gain of NT\$81 million in 2007, partially offset by provision for litigation loss of NT\$1,009 million in 2007. The change from NT\$799 million net loss on settlement and disposal of financial instruments in 2006 to NT\$633 million net gain on settlement and disposal of financial instruments in 2007 was primarily due to lower hedging costs as a result of a lower level of monetary assets and liabilities denominated in foreign currencies in 2007, which we needed to manage exposure due to fluctuation of foreign exchange rates. The change from NT\$813 million net valuation loss on financial instruments in 2006 to NT\$305 million net valuation gain on financial instruments in 2007 was primarily due to a change from a decline in the market value of marketable financial instruments in 2006 to an increase in the market value of marketable financial instruments in 2007. The increase in interest income was primarily the result of a higher level of cash holding and other interest bearing treasury

assets. The change from NT\$401 million net foreign exchange loss in 2006 to a net foreign exchange gain of NT\$81 million in 2007 was primarily due to an appreciation of the NT dollar against the U.S. dollar in 2006 compared to a very moderate appreciation of the NT dollar against the U.S. dollar on spot rate basis in 2007. The provision for litigation loss of NT\$1,009 million in 2007 was related to a lawsuit with UniRAM Technology, Inc.

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Net non-operating income increased by NT\$2,803 million in 2006, or 85.1%, from NT\$3,294 million in 2005 primarily due to a NT\$2,804 million decrease in loss on settlement and disposal of financial instruments, a NT\$1,736 million increase in interest income, a NT\$914 million increase in investment income recognized under the equity method, and a NT\$523 million decrease in interest expense, partially offset by a change from NT\$2,610 million net foreign exchange gain in 2005 to a net foreign exchange loss of NT\$401 million in 2006 and a NT\$476 million increase in net valuation loss on financial instruments. The decrease in loss on settlement and disposal of financial instruments was mainly due to a change from a settlement loss on hedging instruments in 2005 to a settlement gain on hedging instruments in 2006 as a result of a depreciation of the NT dollar against the U.S. dollar in 2005 compared to a very moderate appreciation of the NT dollar against the U.S. dollar in 2006, partially offset by higher hedging costs due to a greater differential between U.S. dollar prevailing interest rates and NT dollar prevailing interest rates in connection with our foreign currency swap transactions in 2006. The increase in interest income was primarily the result of higher interest rates on interest bearing treasury assets and a higher level of cash holding. The increase in investment income recognized under the equity method was primarily due to better operating performance of equity method investees. The decrease in interest expense primarily resulted from a NT\$10,500 million repayment of bonds in 2005. The change from NT\$2,610 million net foreign exchange gain in 2005 to a net foreign exchange loss of NT\$401 million in 2006 was primarily due to a depreciation of the NT dollar against the U.S. dollar in 2005 compared to a very moderate appreciation of the NT dollar against the U.S. dollar on spot rate basis in 2006. The increase in net valuation loss on financial instruments was primarily due to an increased decline in the market value of marketable financial instruments.

*Income Tax Benefit (Expense)***For the Year Ended December 31**

	2005 NT\$ (in millions)	2006 NT\$	% Change from 2005	2007		% Change from 2006
				NT\$ (in millions)	US\$	
Income tax benefit (expense)	(630)	(7,774)	1,132.8%	(11,710)	(361)	50.6%
Cumulative effect of changes in accounting principles		1,607	(1)%			(1)%
Net income	93,575	127,010	35.7%	109,177	3,367	(14.0)%
Net margin	35.1%	40.0%		33.8%	33.8%	

(1) Not meaningful.

Income tax expense increased by NT\$3,936 million in 2007, or 50.6%, from 2006. This increase was mainly due to an increase in taxable income. See Taxation below for a further discussion. In 2008, due to the combined effects of an expected further increase in taxable income and an anticipated further decrease in tax credits, we expect the amount of income tax expense for 2008 will be higher than that in 2007.

Income tax expense increased by NT\$7,144 million in 2006, or 1,132.8%, from 2005. This significant increase was mainly due to the combined effects of a decrease in the tax credit rate applicable to machinery and equipment from 11% in 2005 to 7% in 2006, the expiration of the tax exemption period for some of our 200mm fabs in 2006, and an increase in taxable income.

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On January 1, 2006, we adopted the newly released R.O.C. SFAS No. 34, Accounting for Financial Instruments (SFAS No. 34). Upon adoption of SFAS No. 34, an adjustment of NT\$1,607 million made to the carrying amounts of the financial instruments categorized as financial assets or liabilities at fair value through profit or loss was included in the cumulative effect of changes in accounting principles; and an adjustment of NT\$307 million made to the carrying amounts of those categorized as available-for-sale financial assets was recognized in shareholders' equity.

Liquidity and Capital Resources

Our cash, cash equivalents and current investments in marketable financial instruments amounted to NT\$174,834 million (US\$5,391 million) as of December 31, 2007, down from NT\$195,079 million as of December 31, 2006. Our current investments in marketable financial instruments primarily consist of agency bonds, corporate bonds, asset-backed securities, open-end mutual funds, government bonds, structured time deposits, publicly-traded stocks and a variety of money market funds. Cash and cash equivalents decreased by NT\$22,851 million in 2007, or 19.4%, from 2006, following an increase of NT\$21,353 million in 2006, or 22.1%, from 2005.

	For the year ended December 31,			
	2005⁽¹⁾	2006	2007	
	NT\$	NT\$	NT\$	US\$
	(in millions)		(in millions)	
Net cash provided by operating activities	157,225	204,997	183,766	5,667
Net cash used in investing activities	(77,652)	(119,724)	(70,689)	(2,180)
Net cash used in financing activities	(57,969)	(63,783)	(135,410)	(4,175)
Net increase/(decrease) in cash	22,181	21,353	(22,851)	(705)

(1) As a result of the adoption of the newly released R.O.C. SFAS No. 34 and SFAS No. 36, the amounts for the fiscal year ended December 31, 2005 were reclassified for comparison purposes. Such reclassifications resulted in a change of net cash provided by operating activities from NT\$157,013 million to NT\$157,225 million for the year ended December 31, 2005, and in a change of net cash used in investing activities from

NT\$77,440 million
to
NT\$77,652 million
for the year ended
December 31, 2005.
See note 4 to our
consolidated
financial statements
for additional details
about these new
accounting
standards.

Operating Activities

In 2007, we generated NT\$183,766 million (US\$5,667 million) net cash from operating activities, as compared to NT\$204,997 million in 2006. The decrease in net cash from operating activities was primarily the result of lower net income in 2007 of NT\$109,177 million (US\$3,367 million) compared to NT\$127,010 in 2006, and an increase in notes and accounts receivable of NT\$10,977 million (US\$338 million) in 2007 compared to a decrease in notes and accounts receivable of NT\$6,447 in 2006, partially offset by higher depreciation and amortization in 2007 of NT\$80,005 million (US\$2,467 million) compared to NT\$73,715 million in 2006, an increase in notes and accounts payable of NT\$3,218 million (US\$99 million) in 2007 compared to a decrease in notes and accounts payable of NT\$1,487 in 2006, a decrease in other financial assets of NT\$842 million (US\$26 million) in 2007 compared to an increase in other financial assets of NT\$739 million in 2006, and a lesser increase in inventories of NT\$2,226 million (US\$69 million) in 2007 compared to an increase of NT\$3,702 million in 2006.

In 2006, we generated NT\$204,997 million net cash from operating activities, as compared to NT\$157,225 million in 2005. The increase in net cash from operating activities was primarily the result of higher net income in 2006 of NT\$127,010 million compared to NT\$93,575 in 2005, and a decrease in notes and accounts receivable of NT\$6,447 in 2006 compared to an increase of NT\$10,601 million in 2005 and a decrease of deferred income taxes of NT\$122 million in 2006 compared to an increase in deferred income taxes of NT\$3,353 million in 2005, partially offset by lower depreciation and amortization in 2006 of NT\$73,715 million compared to NT\$75,649 million in 2005.

In 2007, depreciation and amortization expenses were NT\$80,005 million (US\$2,467 million), as compared to NT\$73,715 million in 2006. The increase in depreciation and amortization expenses was primarily due to the continued increased depreciation associated with ramping up Fab 12 (Phases II and III), Fab 14 (Phase II), and Fab 10. We expect depreciation and amortization expenses to increase in 2008, as compared with that in 2007, as we continue to ramp up capacity at Fab 12 and Fab 14, which will be partially offset by the benefits from the reduced depreciation of our 200mm fabs.

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In 2006, depreciation and amortization expenses were NT\$73,715 million, as compared to NT\$75,649 million in 2005. The decrease in depreciation and amortization expenses was primarily due to a decrease in amortization expense of goodwill, which more than offset the continued increased depreciation associated with ramping up Fab 12 (Phases II and III) and Fab 14 (Phase I). Effective January 1, 2006, pursuant to the newly revised R.O.C. SFAS No. 25, Business Combinations Accounting Treatment under Purchase Method (SFAS No. 25), goodwill is no longer amortizable but is tested for impairment annually instead.

Investing Activities

In 2007, net cash used in investing activities was NT\$70,689 million (US\$2,180 million), a significant decrease from NT\$119,724 million in 2006. The decrease in net cash used in investing activities in 2007 was the result of less cash invested in financial assets, and more cash received from disposal or redemption of investment in financial assets, partially offset by more spending on capital expenditures, and an increase in deferred charges and refundable deposits. Capital expenditures in 2007 were primarily related to:

ramping up production at Fab 12 (Phases II and III), Fab 14 (Phase II) and Fab 10;

capacity expansion for mask operations;

developing process technologies which include 32- and 45-nanometer nodes; and

other research and development projects.

Net cash used in investing activities amounted to NT\$119,724 million in 2006, a significant increase from NT\$77,652 million in 2005. The primary cash usage for investing activities for 2005 and 2006 was for capital equipment purchases, which totaled NT\$79,879 million and NT\$78,737 million, respectively.

We currently expect capital expenditures to be approximately US\$1,800 million in 2008, which is likely to fluctuate depending on market conditions. We expect this amount to be spent primarily on ramping up production at Fab 12 (Phase III), Fab 14 (Phase II) and Fab 10; Fab 12 and Fab 14 facilities; capacity expansion for mask and back-end operations; development of process technologies in 45-nanometer and below and other research and development projects. See Item 4. Information on the Company Capacity Expansion and Technology Upgrade Plans for a discussion of our capacity expansion and capital expenditures.

Financing Activities

In 2007, net cash used in financing activities was NT\$135,410 million (US\$4,175 million), as compared to NT\$63,783 million in 2006. The net cash used in financing activities in 2007 primarily reflected payments of cash dividends on our common shares of NT\$77,387 million (US\$2,386 million), repurchase of common shares of NT\$45,413 million (US\$1,400 million), repayment of corporate bonds of NT\$7,000 million (US\$216 million), and payments of employee bonus of NT\$4,573 million (US\$141 million).

In 2006, net cash used in financing activities was NT\$63,783 million, as compared to NT\$57,969 million in 2005. The net cash used in financing activities in 2006 primarily reflected payments of cash dividends on our common stock of NT\$61,743 million, payments of employee bonus of NT\$3,432 million, partially offset by an increase in guarantee deposits of NT\$921 million and proceeds from exercise of stock options of NT\$575 million.

As of December 31, 2007, we had no short-term debt, and the current portion of our long-term debt was NT\$281 million (US\$9 million) and our aggregate long-term debt was NT\$14,222 million (US\$439 million). NT\$649 million (US\$20 million) of the long-term debt were denominated in U.S. dollars. To protect against reductions in value and the volatility of asset value caused by changes in foreign exchange rates, we utilized derivative financial instruments, including currency forward contracts and cross currency swaps, to hedge our currency exposure. See Item 11. Quantitative and Qualitative Disclosures About Market Risk for a discussion of the hedging instruments used. NT\$649 million of the long-term bank loans had floating interest rates based on the London interbank offer rate, or LIBOR. NT\$12,500 million of the long-term bonds had fixed interest rates ranging from 2.75% to 3.00%. As of December 31, 2007, we had an aggregate of approximately NT\$33,660 million (US\$1,038 million) in unused short-term credit lines and an aggregate of approximately NT\$8,532 million (US\$263 million) in unused long-term credit lines.

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The loan agreements, and credit facilities for the obligations of our consolidated subsidiaries contain covenants which, if violated, could result in our obligations under these agreements becoming due prior to the originally scheduled maturity dates. As of February 29, 2008, we were in compliance with our financial covenants.

Cash Requirements

The following table sets forth the maturity of our long-term debt (bank loans and bonds) outstanding as of December 31, 2007:

	Long-term debt NT\$ (in millions)
During 2008	281
During 2009	8,302
During 2010	947
During 2011	221
During 2012 and thereafter	4,752

The following table sets forth information on our material contractually obligated payments for the periods indicated as of December 31, 2007:

Contractual Obligations	Total	Payments Due by Period			More than 5 Years
		Less than 1 Year	1-3 Years	4-5 Years	
		(in NT\$ millions)			
Long-Term Debt ⁽¹⁾	14,503	281	9,249	4,872	101
Capital Lease Obligations ⁽²⁾	726	4	83	81	558
Operating Leases ⁽³⁾	4,463	557	1,004	623	2,279
Other Payments ⁽⁴⁾	13,083	3,673	1,080	422	7,908
Capital Purchase or other Purchase Obligations ⁽⁵⁾	36,831	35,736	1,092	3	
Total Contractual Cash Obligations⁽⁶⁾	69,606	40,251	12,508	6,001	10,846

(1) Includes loan payable and bond payable but excludes relevant interest payments.

(2) Capital lease obligations represent our commitment for leases of property, which are described in note 13 to our consolidated financial statements.

- (3) Operating lease obligations are described in note 27 to our consolidated financial statements.
- (4) Includes royalty and license payments, as well as payables for acquisition of property, plant and equipment, but excludes payments that vary based upon our net sales of certain products and our sales volume of certain other products.
- (5) Represents commitments for construction or purchase of equipment, raw material and other property or services. These commitments are not recorded on our balance sheet as of December 31, 2007, as we have not received related goods or taken title of the property.
- (6) Minimum pension funding requirement is not included

since such amounts have not been determined. We made pension contributions of approximately NT\$209 million in 2007 and we estimate that we will contribute approximately NT\$204 million to the pension fund in 2008. See note 18 to our consolidated financial statements for additional details regarding our pension plan.

During 2007, we entered into derivative financial instruments transactions to manage exposures related to foreign-currency denominated receivables or payables. As of December 31, 2007, our cash requirements in 2008 for outstanding forward exchange contracts and cross currency swaps contracts were approximately US\$1,086 million and EUR\$48 million with our expected cash receipts of approximately NT\$37,327 million. See Item 11. Quantitative and Qualitative Disclosures about Market Risk for more information regarding our derivative financial instruments transactions. See also note 2 to the consolidated financial statements for our accounting policy of derivative financial

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instruments and note 25 to the consolidated financial statements for additional details regarding our derivative financial instruments transactions.

We do not generally provide letters of credit to, or guarantees for any entity other than our consolidated subsidiaries.

We require significant amounts of capital to build, expand, upgrade and maintain our production facilities and equipment. We made capital expenditures of NT\$79,879 million, NT\$78,737 million and NT\$84,001 million (US\$2,590 million) in 2005, 2006 and 2007, respectively. We currently expect that our plans for ramping up production at Fab 12 (Phase III), Fab 14 (Phase II) and Fab 10; Fab 12 and Fab 14 facilities; capacity expansion for mask and back-end operations; development of process technologies in 45-nanometer and below and other research and development projects will require capital expenditures in 2008 of approximately US\$1,800 million, which may likely fluctuate depending on market conditions.

We expect to fund our expansion projects and other cash requirements primarily with internally generated funds. In the future, we may consider debt and equity financing, depending on market conditions, our financial performance and other relevant factors. In particular, an extended industry downturn could adversely affect our profitability and internal generation of cash, and thereby increase our reliance on external sources of funds. We believe that our working capital, cash flow from operations and unused lines of credit will provide sufficient resources to meet our planned capital requirements.

U.S. GAAP Reconciliation

Our consolidated financial statements are prepared in accordance with R.O.C. GAAP, which differs in certain material aspects from U.S. GAAP. The following table sets forth a comparison of our net income and shareholders equity in accordance with R.O.C. GAAP and U.S. GAAP for the periods indicated:

	Year ended and as of December 31,			
	2005	2006	2007	US\$
	NT\$	NT\$	NT\$	
	(in NT\$ millions)			
Net income in accordance with:				
R.O.C. GAAP	93,575	127,010	109,177	3,367
U.S. GAAP	75,418	95,711	71,658	2,210
Shareholders' equity attributable to the shareholders of the parent in accordance with:				
R.O.C. GAAP	445,631	507,981	487,092	15,020
U.S. GAAP	477,297	532,403	513,228	15,826

Note 30 to the consolidated financial statements provides a description of the principal differences between R.O.C. GAAP and U.S. GAAP as they relate to us, and a reconciliation to U.S. GAAP of certain items, including net income and shareholders' equity. Differences between R.O.C. GAAP and U.S. GAAP that have a material effect on our net income as reported under R.O.C. GAAP include compensation expense pertaining to stock bonuses to employees, marketable securities, impairment charges for long-lived assets, amortization of goodwill, and 10% tax imposed on unappropriated earnings.

In July 2007, we distributed an aggregate bonus of NT\$9,146 million, or 8% of our 2006 distributable net income, to our employees, 50% of which was paid in cash and 50% of which was paid in the form of common shares. The number of common shares distributed as part of employee bonuses is obtained by dividing the total nominal NT dollar amount of the bonus to be paid in the form of common shares by the par value of the common shares, at NT\$10 per share, rather than their market value, which has generally been substantially higher than the par value. Under R.O.C. GAAP, the distribution of employee bonus shares is treated as an allocation from retained earnings, and we are not required to, and do not, charge the value of the employee bonus shares against income. Under U.S. GAAP, however, we are required to charge the market value of the employee bonus shares as employee compensation expense, which reduces our net income and income per share calculated in accordance with U.S. GAAP. Since the amount and the form of the payment of the compensation is subject to shareholder approval and only determinable at the annual

shareholders meeting, which is generally held after the issuance of our financial statements, under U.S. GAAP, the compensation expense is initially accrued at the nominal NT dollar amount of the aggregate bonus in the period to

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which it relates as if it were to be paid entirely in cash. The difference between the amount initially accrued and the market value of the common shares and cash issued as payment of all or any part of the bonus is recorded as employee compensation expense in the year in which shareholder approval is obtained. Therefore, net income and income per share amounts calculated in accordance with R.O.C. GAAP and U.S. GAAP differ accordingly. For a more detailed discussion, please refer to note 30.g. to the consolidated financial statements.

Prior to 2006, under R.O.C. GAAP, investments in marketable securities were stated at the lower of aggregate cost or market value, with the market value determined using the average-closing price during the last month of the period. Investments in debt securities were carried at amortized cost. An allowance was recognized for any temporary decline in the market value of investments with readily ascertainable fair market value with the corresponding amount recorded as an unrealized loss presented as a separate item in shareholders' equity. The carrying values of investments whose fair market values were not readily determinable were reduced to reflect an other-than-temporary decline in their values, with the related impairment loss charged to income. Under U.S. GAAP, debt and equity securities that have readily determinable fair market values are classified as either trading, available-for-sale or held-to-maturity securities. Trading securities are reported at fair value, with unrealized gains and losses included in the accompanying statements of income. Available-for-sale securities are also reported at fair value, with unrealized gains and losses reported as a separate component of shareholders' equity. Additionally, under U.S. GAAP, fair market value of listed stocks is determined using the closing price of the listed stock on the last trading day for the period. Beginning from 2006, we adopted the R.O.C. SFAS No. 34, Financial Instruments: Recognition and Measurement, and No. 36,

Financial Instruments: Disclosure and Presentation. Under these new R.O.C. accounting pronouncements, financial instruments, which include debt and equity securities, are categorized as either financial assets or liabilities at fair value through profit or loss, available-for-sale, or held-to-maturity securities. Financial assets or liabilities at fair value through profit or loss are divided into two sub-categories, financial assets designated on initial recognition as one to be measured at fair value and those that are classified as held for trading, which are also measured at fair value with fair value changes recognized in profit and loss. Thus, the classifications and valuation methodology for debt and equity securities under these new R.O.C. accounting pronouncements are similar to those required by U.S. SFAS No. 115,

Accounting for Certain Investments in Debt and Equity Securities. As a result of adopting R.O.C. SFAS No. 34, a favorable impact of NT\$1,607 million was recorded as cumulative effect of changes in accounting principles in 2006 under R.O.C. GAAP to adjust the carrying basis of trading securities, which were previously recorded at the lower of aggregate cost or market value, to fair market value, which is a one-time reconciling adjustment between R.O.C. and U.S. GAAP in 2006.

For purposes of U.S. GAAP, we are required to periodically evaluate the recoverability of the carrying amount of our long-lived assets. Whenever events or changes in circumstances indicate that the carrying amounts of those assets may not be recoverable, we are required to compare undiscounted net cash flows estimated to be generated by those assets to the carrying value of those assets. To the extent that cash flows are less than the carrying value of the assets, we are required to record impairment losses for the difference between the carrying value and the fair value of the assets. Prior to 2005, under R.O.C. GAAP, we were not required to record impairment losses of assets that could still be used in the business but were required to evaluate the impairment losses of idle assets which were purchased for use in the business but subsequently determined to have no use. Beginning from 2005, under R.O.C. GAAP, when an indication of impairment is identified, any excess of the carrying amount of an asset over its recoverable amount is recognized as a loss. If the recoverable amount increases in a future period, the amount previously recognized as impairment would be reversed and recognized as a gain, to the extent of the carrying amount that would have been determined, net of depreciation, as if no impairment loss had been recognized. Please see note 30.c. to the consolidated financial statements for a more detailed discussion of the impairment of long-lived assets and U.S. SFAS No. 144.

Under R.O.C. GAAP, prior to January 1, 2006, goodwill was amortized over ten years. Under U.S. GAAP, prior to January 1, 2002, goodwill was amortized over five or ten years. Effective January 1, 2002, we adopted U.S. SFAS No. 142, Goodwill and Other Intangible Assets. In accordance with U.S. SFAS No. 142, goodwill is no longer amortized, and instead is assessed for impairment on at least an annual basis. In connection with our acquisition of TSMC-Acer, goodwill from the 1999 acquisition of the initial 32% equity interest in TSMC-Acer was recognized for

R.O.C. GAAP purposes since the goodwill was from an acquisition paid in cash. However, goodwill from the 2000 acquisition of the remaining 68% equity interest in TSMC-Acer was not recognized under R.O.C. GAAP. Rather it was netted against capital surplus since the goodwill was from a business combination in the form of a share exchange. Under U.S. GAAP, goodwill from both acquisitions was recognized. Effective January 1, 2006, under R.O.C. GAAP, goodwill is no longer amortized and is assessed for impairment on at least an annual basis.

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In R.O.C., a 10% tax is imposed on any unappropriated earnings. For R.O.C. GAAP purposes, we record the 10% tax on unappropriated earnings in the year of shareholders approval. Under U.S. GAAP, the 10% tax on unappropriated earnings should be accrued during the period the earnings arise and adjusted to the extent that distributions are approved by the shareholders in the following year. An expense is recognized in the year in which earnings are recorded under U.S. GAAP, which may be offset by available tax credits.

Taxation

We are eligible for four-year and five-year tax holidays for income generated from construction and capacity expansions of production facilities according to the regulation for Science Park Administration and the Statute for Upgrading Industries of the R.O.C., respectively. The exemption period may begin at any time within four or five years, as applicable, following the completion of a construction or expansion. The aggregate tax benefits of such exemption periods in 2005, 20