
ALPHA NETWORKS INC. AND SUBSIDIARIES
Consolidated Financial Statements
December 31, 2004
(With Independent Auditors' Report Thereon)

Independent Auditors' Report

The Board of Directors
Alpha Networks Inc.:

We have audited the consolidated balance sheets of Alpha Networks Inc. and subsidiaries as of December 31, 2004, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the Republic of China. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Alpha Networks Inc. and subsidiaries as of December 31, 2004, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the Republic of China.

Pursuant to the ruling issued by ROC Accounting Research and Development Foundation on November 4, 1986, the consolidated financial statements of Alpha Networks Inc. and subsidiaries as of and for the year ended December 31, 2003 were not retroactively prepared and presented for comparison as 2004 is the first year that Alpha Networks Inc. is required to prepare and present its consolidated financial statements.

KPMG Certified Public Accountants

Hsinchu, Taiwan (the Republic of China)
March 21, 2005

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

ALPHA NETWORKS INC. AND SUBSIDIARIES

Consolidated Balance Sheet

December 31, 2004

(in thousands of New Taiwan dollars)

	2004	2004
Assets		
Current assets:		
Cash and cash equivalents (note 3)	\$ 915,526	
Short-term investments (note 4)	438,045	
Notes and accounts receivable, net (note 5)	784,534	
Receivables from related parties (note 14)	1,979,136	
Other financial assets — current (note 13)	43,451	
Inventories (note 6)	1,453,217	
Other current assets (note 11)	<u>77,344</u>	
Total current assets	<u>5,691,253</u>	
Long-term equity investments under cost method (note 7)		
Other financial assets — noncurrent (note 15)	16,985	
Property, plant and equipment (notes 6 and 14):	<u>15,327</u>	
Buildings and improvements	1,485,832	
Machinery and equipment	747,968	
Other equipment	<u>142,024</u>	
Less: accumulated depreciation	2,375,824	
Prepayment for purchases of machinery and equipment	<u>527,717</u>	
Net property, plant and equipment	<u>21,373</u>	
Other assets:	<u>1,869,480</u>	
Deferred expenses and others (note 14)	212,067	
Net deferred income tax assets (note 11)	<u>32,028</u>	
Total other assets	<u>244,095</u>	
Total assets	<u>\$ 7,837,140</u>	
Liabilities and Stockholders' Equity		
Current liabilities:		
Short-term borrowings (note 8)		\$ 1,196,827
Accounts payable		1,863,307
Payables to related parties (note 14)		74,023
Accrued expenses		443,938
Other current liabilities		<u>214,761</u>
Total current liabilities		<u>3,792,856</u>
Other liabilities:		
Accrued pension liabilities (note 9)		45,195
Deferred credit and others		<u>2,764</u>
Total other liabilities		<u>47,959</u>
Total liabilities		<u>3,840,815</u>
Stockholders' equity (note 10):		
Common stock		2,500,000
Capital surplus		<u>754,773</u>
Retained earnings:		
Legal reserve		4,578
Unappropriated earnings		740,246
Foreign currency translation adjustment		<u>744,824</u>
Total stockholders' equity		<u>(3,272)</u>
Total liabilities and stockholders' equity		<u>\$ 7,837,140</u>
Commitments and contingencies (note 16)		
Total liabilities and stockholders' equity		<u>\$ 7,837,140</u>

See accompanying notes to consolidated financial statements.

ALPHA NETWORKS INC. AND SUBSIDIARIES

Consolidated Statement of Income

Year ended December 31, 2004

(in thousands of New Taiwan dollars, except for net income per common share)

2004

Sales (note 14)	\$	14,082,845
Cost of goods sold (note 14)		<u>11,416,815</u>
Gross profit		<u>2,666,030</u>
Operating expenses (note 14):		
Selling		329,584
Administrative		372,948
Research and development		<u>1,010,094</u>
		<u>1,712,626</u>
Operating income		<u>953,404</u>
Non-operating income:		
Interest income		1,599
Gain on disposal of short-term investments		20,700
Other income, net		<u>36,931</u>
		<u>59,230</u>
Non-operating loss:		
Interest expense		28,196
Loss on disposal of property, plant and equipment		2,189
Loss on inventory obsolescence and devaluation		165,088
Exchange loss, net		<u>45,918</u>
		<u>241,391</u>
Income before income taxes		771,243
Income tax expenses (note 11)		<u>66,222</u>
Net income	\$	<u><u>705,021</u></u>
		Before After
Net income per common share (note 12)		taxes taxes
Basic earnings per common share	\$	<u><u>3.14</u></u> <u><u>2.87</u></u>
Diluted earnings per common share	\$	<u><u>2.96</u></u> <u><u>2.71</u></u>

See accompanying notes to consolidated financial statements.

ALPHA NETWORKS INC. AND SUBSIDIARIES
Consolidated Statement of Changes in Stockholders' Equity
Year ended December 31, 2004
(in thousands of New Taiwan dollars)

	Common stock	Advance receipts for common stock	Capital surplus	Legal reserve	Unapprop- riated earnings	Foreign currency translation adjustment	Total stockholders' equity
Balance at January 1, 2004	\$ 2,000,000	900,000	354,773	-	45,777	524	3,301,074
Issuance of common stock for cash	500,000	(900,000)	400,000	-	-	-	-
Appropriation of earnings:							
Legal reserve	-	-	-	4,578	(4,578)	-	-
Employees' bonuses	-	-	-	-	(5,150)	-	(5,150)
Directors' and supervisors' remuneration	-	-	-	-	(824)	-	(824)
Net income for 2004	-	-	-	-	705,021	-	705,021
Foreign currency translation adjustment	-	-	-	-	-	(3,796)	(3,796)
Balance at December 31, 2004	<u>\$ 2,500,000</u>	<u>-</u>	<u>754,773</u>	<u>4,578</u>	<u>740,246</u>	<u>(3,272)</u>	<u>3,996,325</u>

See accompanying notes to consolidated financial statements.

ALPHA NETWORKS INC. AND SUBSIDIARIES

Consolidated Statement of Cash Flows

Year ended December 31, 2004

(in thousands of New Taiwan dollars)

2004

Cash flows from operating activities:	
Net income	\$ 705,021
Adjustments to reconcile net income to net cash used in operating activities:	
Depreciation and amortization	423,253
Provision for inventory obsolescence and devaluation loss, and allowance for doubtful accounts	177,088
Loss on disposal of property, plant and equipment	2,189
Other loss with no cash impacts	9,510
Increase in inventories	(1,618,304)
Increase in deferred income tax assets	(5,110)
Increase in notes and accounts receivable (including related parties)	(2,551,968)
Increase in accounts payables (including related parties)	1,921,528
Decrease in accrued pension	(200,024)
Increase in other operation-related current assets	(118,035)
Increase in other operation-related current liabilities	<u>693,826</u>
Cash used in operating activities	<u>(561,026)</u>
Cash flows from investing activities:	
Increase in long-term equity investments	(74,891)
Decrease in short-term investments	466,462
Proceeds from disposal of property and equipment	32,773
Acquisition of property and equipment	(375,530)
Increase in deferred expenses	(174,607)
Increase in deposits and other assets	<u>(5,588)</u>
Cash used in investing activities	<u>(131,381)</u>
Cash flows from financing activities:	
Increase in short-term borrowings	489,817
Payments of directors' and supervisors' remuneration, and employees' bonuses	<u>(5,974)</u>
Cash provided by financing activities	<u>483,843</u>
Effect of exchange rate changes on cash	<u>(29,133)</u>
Net decrease in cash and cash equivalents	(237,697)
Cash and cash equivalents at beginning of year	<u>1,153,223</u>
Cash and cash equivalents at end of year	\$ <u>915,526</u>
Supplemental disclosures of cash flow information:	
Cash payments of interest	\$ <u>25,671</u>
Cash payments of income taxes	\$ <u>17,931</u>

See accompanying notes to consolidated financial statements.

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2004

(amounts expressed in thousands of New Taiwan dollars,
except for per share information and unless otherwise noted)

1. Organization and Principal Activities

Alpha Networks Inc. ("Alpha ") was established by a spin-off whereby on August 16, 2003, D-Link Corporation ("D-Link") separated its original design manufacturing and original equipment manufacturing ("ODM/OEM") operations from its D-Link brand business and transferred related operating assets and liabilities to Alpha. Alpha was incorporated on September 4, 2003, as a company limited by shares under the laws of the Republic of China ("ROC") and the ROC Statute for the Establishment and Administration of the Science-Based Industrial park. The shares of the Company have been traded on the Taiwan Stock Exchange since December 20, 2004.

Alpha's main activities include the research, development, production and sale of broadband products, computer network systems, wireless local area networks ("LANs"), and relevant spare parts.

As of December 31, 2004, Alpha and subsidiaries had 3,811 employees.

Alpha's parent company is D-Link.

For the purpose of preparing the accompanying consolidated financial statements, an entity is deemed a subsidiary if Alpha directly or indirectly owns 50% or more of its voting stock. The consolidated subsidiaries of Alpha are summarized below.

	Investor	Percentage of ownership at December 31, 2004
1. Alpha Solutions Co., Ltd. (Alpha Solutions)	Alpha	100
2. Redsonic Technology Co. (Redsonic)	Alpha	100
3. Alpha Holdings Inc. (Alpha Holdings)	Alpha	100
• D-Link Asia Investment Pte. Ltd. (D-Link Asia)	Alpha Holdings	100
- D-Link Dongguan Ltd. (D-Link Dongguan)	D-Link Asia	100
• Tong Ying Trading (Shenzhen) Co., Ltd. (Tong Ying)	Alpha Holdings	100
• Alpha Networks (Chengdu) Co., Ltd. (Alpha Chengdu)	Alpha Holdings	100
4. Des Voeux Ltd. (Des Voeux)	Alpha	100
• Alpha Networks Inc. (Alpha U.S.A.)	Des Voeux	100

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ALPHA NETWORKS INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements****2. Summary of Significant Accounting Policies****(1) Accounting principles and consolidation policy**

These consolidated financial statements are not intended to present the financial position and the related results of operations and cash flows of Alpha and its subsidiaries based on accounting principles and practices generally accepted in countries and jurisdictions other than the ROC.

The consolidated financial statements include the accounts of Alpha and subsidiaries in which Alpha directly or indirectly owns greater than 50 percent of the subsidiary's voting shares and is able to exercise control over the subsidiary's operations and financial policies (collectively, the "Company"). However, if a subsidiary's total assets and revenues do not exceed 10% of Alpha's total assets and revenues and the unconsolidated subsidiaries' total assets and revenues do not exceed 30% of Alpha's total assets and revenues, the subsidiaries could be excluded from consolidation and are accounted for under the equity method in the accompanying consolidated financial statements. All significant inter-company balances and transactions are eliminated in consolidation.

The difference between the net purchase price and the net equity of the acquired subsidiary is accounted for as consolidated debit (included in "other assets" in the accompanying consolidated balance sheet) and amortized 5 years using the straight-line method.

(2) Foreign currency transactions and translation

The Company records transactions in their respective local currencies. Foreign currency transactions are recorded at the exchange rate prevailing on the transaction date. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies are translated using the exchange rates on that date. The resulting exchange gains or losses from settlement of such transactions or translation of monetary assets and liabilities are reflected in the accompanying consolidated statement of income.

The financial statements of foreign subsidiaries are translated into New Taiwan dollars at the exchange rates prevailing on the balance sheet date, with the exception of stockholders' equity, which is translated at historical rates, and revenues, costs and expenses, which are translated at the weighted-average exchange rates during the reporting period. Translation differences resulting from the translation of such financial statements into New Taiwan dollars are recorded as a foreign currency translation adjustment, a separate component of stockholders' equity.

(3) Cash equivalents

The Company considers all highly liquid investments, such as investments in bonds with repurchase agreements, with a maturity of three months or less to be cash equivalents.

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ALPHA NETWORKS INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements****(4) Short-term investments**

Short-term investments are stated at the lower of cost or market value. Market value is determined using the net asset value of open-end mutual funds on the last day of the period.

(5) Allowance for doubtful accounts

The allowance for doubtful accounts is determined based on the ageing, credit evaluation results, past experience and the Company's internal credit policies.

(6) Inventories

Inventories are stated at the lower of cost or market value. Cost is determined by the weighted-average method. The market value of raw materials is determined on the basis of replacement cost, and the market values of finished goods and work in process are determined on the basis of net realizable value.

(7) Long-term equity investments

Long-term equity investments in which Alpha directly or indirectly, owns less than 20 percent of the investee's voting shares and is not able to exercise significant influence over the investee's operations and financial policies are accounted for by the cost method. If there is evidence indicating that a decline in the value of such an investment is other than temporary, then the carrying amount of the investment is reduced to reflect its net realizable value. The related loss is recognized in the accompanying consolidated statement of income.

Long-term equity investments in which Alpha, directly or indirectly, more than 20 percent of the investee's voting shares, or less than 20 percent of the investee's voting shares but is able to exercise significant influence over the investee's operations and financial policies, are accounted for by the equity method. The difference between the acquisition cost and the net equity of the investee as of the acquisition date is deferred and amortized over five years using the straight-line method, and the amortization is recorded as investment income or loss in the accompanying consolidated statement of income.

All significant inter-company gains or losses with investees accounted for under the equity method are deferred. These gains or losses are recognized in the year that the gain or loss is realized through a third-party transaction or over the remaining useful life of property, plant and equipment.

(8) Property, plant and equipment

Property, plant and equipment are stated at cost. Costs associated with significant additions, improvements, and replacements to property, plant and equipment are capitalized. Repairs and maintenance are charged to expenses as incurred.

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ALPHA NETWORKS INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements**

Depreciation of property, plant and equipment of the Company is provided for by using the straight-line method over the estimated useful lives of the respective assets. The useful lives of property, plant and equipment are as follows:

- (a) Buildings and improvements: 5~50 years.
- (b) Machinery and equipment: 3~10 years.
- (c) Transportation: 3~10 years.
- (d) Office equipment and others: 3~8 years.

Gains or losses on the disposal of property, plant and equipment are accounted for as non-operating income or losses in the consolidated statement of income.

(9) Deferred expenses

The purchase costs of software and intellectual property rights are recorded as deferred expenses and are amortized over periods ranging from three to five years, on a straight-line basis.

(10) Derivative financial instruments

(a) Forward foreign currency exchange contracts

Forward foreign currency exchange contracts are purchased to hedge currency fluctuations affecting foreign currency receivables and payables. These forward exchange contract receivables and payables are recorded at the spot rate at the date of inception. The difference between the forward and the spot rate on the date the contract is entered into is amortized as an exchange gain or loss over the term of the contract. Realized and unrealized gains and losses on these contracts resulting from actual settlement or balance sheet date translation are charged or credited to current operations.

(b) Foreign currency option contracts

Foreign currency option contracts are not entered into for trading purposes. For those contracts entered into to hedge the risk of assets and liabilities, gain or losses on these contracts resulting from actual exercise and settlement are charged or credited to current operations. Contracts which are not qualified as effective hedge are marked to market on the balance sheet date. The differences between the market value and book value are charged or credited to current operations.

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ALPHA NETWORKS INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements****(11) Retirement plan**

Alpha and Redsonic have established employee noncontributory retirement plans (the "Plans") covering all regular employees in Taiwan. In accordance with the Plans, employees are eligible for retirement or are required to retire after meeting certain age or service requirements. Payments of retirement benefits are based on years of service and the average salary for the six-month period before the employee's retirement. Each employee earns two months of salary for the first fifteen years of service, and one month of salary for each year of service thereafter. The maximum retirement benefit is 45 months of salary. Pursuant to ROC labor standard law, Alpha and Redsonic contribute 2 percent of wages and salaries to a pension fund maintained with the Central Trust of China on a monthly basis. Retirement benefits are paid to eligible participants on a lump-sum basis upon retirement.

Alpha and Redsonic perform actuarial calculations of their pension obligation as of each year-end. Based on the actuarial calculation, Alpha and Redsonic recognize net periodic pension costs include service cost, interest cost, actual return of pension fund and unrecognized transition obligation amortized over the remaining service period of employees by using the straight-line method.

Alpha Solutions, Alpha Holdings, Des Voeux, etc., did not establish pension plan and therefore, no pension expense was recognized.

Alpha's foreign subsidiary Alpha U.S.A. has a defined contribution retirement plan. This plan is funded in accordance with the regulations of the U.S.A. Contributions to this plan are expensed as incurred.

(12) Revenue recognition

Sales revenue is recognized when title to the products and the risks and rewards of ownership are transferred to the customers, which occurs principally at the time of shipment. Outsourcing revenue is recognized when title to the products is transferred to the customers, which occurs principally at the time of shipment.

(13) Income taxes

Income taxes are accounted for under the asset and liability method. Deferred income taxes are determined based on differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect during the years in which the differences are expected to reverse. The income tax effects resulting from taxable temporary differences are recognized as deferred income tax liabilities. The income tax effects resulting from deductible temporary differences, net operating loss carryforwards, and income tax credits are recognized as deferred income tax assets. The realization of deferred income tax assets is evaluated, and if it is considered more likely than not that the deferred tax assets will not be realized, a valuation allowance is recognized accordingly.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Classification of deferred income tax assets or liabilities as current or noncurrent is based on the classification of the related asset or liability. If the deferred income tax asset or liability is not directly related to a specific asset or liability, then the classification is based on the expected realization date of such asset or liability.

Income tax expense is reduced by investment tax credits derived from expenditures of purchases of equipment and technologies, research and development and personal training in the year in which the credits arise.

According to the ROC Income Tax Law, undistributed earnings of Alpha and its subsidiaries in the ROC are subject to an additional 10 percent corporate income surtax. The surtax is charged to income tax expense after the appropriation of earnings is approved by the stockholders in the following year.

(14) Net income per common share

Net income per common share is calculated based on the weighted-average number of common shares outstanding during the period. The effect on net income per common share from the increase in stock from the transfer of unappropriated earnings, capital surplus, and employee bonuses is computed retroactively.

Employee stock options issued by Alpha are potential common stock. If there is a dilutive effect, both basic and dilutive net income per common share will be disclosed. If there is no dilutive effect, only basic net income per common share will be disclosed.

3. Cash and Cash Equivalents

	December 31, 2004
Cash on hand	\$ 18,042
Checking and saving accounts	165,507
Time deposits	726,975
Cash equivalents-bonds with repurchase agreements	<u>5,002</u>
	<u>\$ 915,526</u>

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

4. Short-term Investments

	December 31, 2004
Mutual funds	\$ <u>438,045</u>
Market value	\$ <u>438,587</u>

5. Notes and Accounts Receivable, Net

	December 31, 2004
Notes receivable	\$ 41
Accounts receivable	796,493
Less: allowance for doubtful accounts	<u>(12,000)</u>
	\$ <u>784,534</u>

6. Inventories

	December 31, 2004
Merchandise	\$ 76
Finished goods	222,950
Work in process	412,407
Raw materials	905,130
Provision for devaluation	<u>(87,346)</u>
	\$ <u>1,453,217</u>
Insurance coverage on inventories	\$ <u>2,739,140</u>

As of December 31, 2004, insurance coverage of property, plant and equipment amounted to \$2,157,734 thousand.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

7. Long-term equity investments

Long-term equity investments and related investment income or loss as of and for the year ended December 31, 2004, is summarized below:

Cost method:	Investee	December 31, 2004	
		Book value	Percentage of ownership
TGC, Inc.		<u>\$ 16,985</u>	1

For the purpose of expanding the market of networking products in Mainland China, Alpha invested \$16,985 thousand in TGC, Inc. in September 2004 and obtained 0.83% of the voting shares.

8. Short-term Borrowings

Short-term borrowings consisted of the following as of December 31, 2004:

	2004	
	Amount	Rate %
Usance loan	\$ 546,440	2.43%~ 3.081%
Unsecured borrowings	<u>650,387</u>	0.796%~ 2.85%
	<u>\$ 1,196,827</u>	
Unused credit facilities	<u>\$ 3,440,563</u>	

Unsecured borrowings of \$262,348 thousand were guaranteed by D-Link.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

9. Retirement Plans

The following table sets forth the benefit obligation and accrued pension balance as of December 31, 2004:

	2004
Benefit obligation:	
Nonvested benefit obligation	\$ (167,724)
Vested benefit obligation	-
Accumulated benefit obligation	<u>(167,724)</u>
Projected future salary increase	<u>(117,992)</u>
Projected benefit obligation	(285,716)
Fair value of plan assets	<u>245,226</u>
Funded status	(40,490)
Unrecognized net loss	<u>(4,705)</u>
Accrued pension cost	<u>\$ (45,195)</u>

The components of Alpha's net periodic pension cost for 2004 are summarized as follows:

	2004
Service cost	\$ 35,005
Interest expenses	8,583
Actual returns on pension fund	(1,866)
Amortization	<u>1,615</u>
	<u>\$ 43,337</u>

Actuarial assumptions at December 31, 2004, are summarized as follows:

	2004
Discount rate	3.50%
Rate of increase in future compensation levels	3.00%
Expected long-term rate of return on plan assets	3.50%

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

The number of the Company's employees transferred from D-Link's OEM/ODM division during the spin-off on August 16, 2003 is 1,351. The Company recognizes the service seniority and retirement obligation of these employees for their services with D-Link. Due to the limitation of regulations, D-Link can not transfer the pension fund that it contributed and deposited with the Central Trust of Chain before the spin-off. Therefore, D-Link paid Alpha seniority compensation of \$226,537 thousand based on an actuarial calculation. To protect the employees' benefit and rights, Alpha had fully contributed such seniority compensation received from D-Link to the pension fund maintained with the Central test of Chain in May 2005.

10. Stockholders' Equity

(a) Common stock

Pursuant to a resolution of D-Link stockholders' meeting on August 16, 2003 to spin-off its OEM/ODM division, Alpha was incorporated, the authorized capital amounted to \$3,000,000 thousand (including \$300,000 thousand authorized for the issuance of the employee stock options) and the issued capital amounted to \$2,000,000 thousand. Alpha issued 200,000 thousand shares of common stock at \$10 per share when it was incorporated.

Pursuant to the board of directors' resolution on October 20, 2003, Alpha issued 50,000 thousand shares of common stock for cash at \$18 per share. The capital increase was registered on January 29, 2004.

Alpha issued 30,000 units of employee stock options. Each unit of employee stock options can purchase 1,000 common shares. Pursuant to the board of directors' resolution in August 2003, employee stock options issued were as follows:

Classification	Issue date	Issued units	Option duration	Restricted period	Exercise Price per share (NT\$)
First issuance of Employee stock options in 2004	Jan. 1, 2004	29,720	Jan. 1, 2004~ Dec. 31, 2009	Jan. 1, 2004~ Dec. 31, 2005	15
Second issuance of Employee stock options in 2004	Jan. 30, 2004	80	Jan. 30, 2004~ Jan. 29, 2010	Jan. 30, 2004~ Jan. 29, 2006	15

The above employee stock options have not been exercised.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Pursuant to regulations of ROC SFB and the ruling of ROC Accounting Research and Development Foundation ("ARDF"), the compensation cost of stock options is recognized by using the intrinsic value method, which is zero because the exercise price of options is higher than the net equity per share of Alpha's common stock based on the latest audited financial statements.

If the compensation cost of employee stock options were accounted for by using the fair-value method and the Black-Scholes model is used to estimate the fair value of employee stock options granted, the fair value of each unit of employee stock options would be \$0.6. Weighted-average assumptions are summarized as follows:

	2004
Expected dividend yield	15%
Expected volatility	37.16%
Risk-free interest rate	1.98%
Expected life	6 years

Information related to Alpha's employee stock option plan for the year ended December 31, 2004, was as follows:

	Options (thousands)	2004 Weighted- average exercise price (dollars)
For the year ended December 31		
Outstanding at beginning of year	-	-
Granted	29,800	15.0
Exercised	-	-
Forfeited	(679)	-
Outstanding at end of year	<u>29,121</u>	
Exercisable at end of year	<u>29,121</u>	
Weighted-average fair value of options granted during the year (NT\$)	<u>\$ 0.60</u>	

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

If the compensatory employee stock option plan adopted the fair-value method, the pro forma net income and earnings per common share on the accompanying consolidated financial statements are as follows:

		2004
Net income	Net income	\$ 705,021
	Pro forma net income	702,836
Basic earnings per common share	Earnings per common share	2.87
	Pro forma earnings per common share	2.86
Diluted earnings per common share	Earnings per common share	2.71
	Pro forma earnings per common share	2.70

As of December 31, 2004, the authorized common stock amounted to \$3,000,000 thousand and the issued and outstanding common stock was \$2,500,000 thousand, at a par value of ten New Taiwan dollars.

(b) Capital surplus

	2004
Additional paid-in capital generated from the excess of net assets transferred by D-Link exceeds the par value of share capital issued to D-Link	\$ 354,773
Additional paid-in capital	<u>400,000</u>
	<u>\$ 754,773</u>

Pursuant to the ROC Company Law, with the exception of capital surplus originating from long-term equity investments accounted for by the equity method, capital surplus can only be used to offset a deficit and cannot be used to declare cash dividends. However, capital surplus derived from additional paid-in capital and earnings from gifts received can be used to increase share capital if there is no accumulated deficit. According to current SFB regulations, capitalization of capital surplus cannot exceed a rate of ten percent and can be done only in years after the year in which such capital increase is registered with the authorities.

(c) Distribution of earnings and dividend policy

According to the ROC Company Law, Alpha must retain 10% of its annual income as a legal reserve until such retention equals the amount of authorized common stock. The retention is accounted for by transfers to a legal reserve upon approval at a stockholders' meeting. The legal reserve can only be used to offset an accumulated deficit, and when it reaches an amount equal to one-half of the paid-in share capital, one-half of legal reserve may be transferred to common stock.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

After establishing the legal and special reserve, earnings may be distributed in the following order in accordance with Alpha's articles of incorporation: 2% as remuneration to directors and supervisors and 12.5% as employee bonuses. An additional reserve on certain earnings may also be retained. The remaining earnings may be distributed as stockholders' dividends.

According to ROC SFB regulations, a publicly listed company should retain a special reserve equal to any deductions made to stockholders' equity related to items such as foreign currency translation adjustments before distribution of earnings. If the aforementioned deduction of stockholders' equity is reversed, the same amount could be removed from special reserve and transferred to unappropriated earnings.

Alpha has adopted the remaining dividend policy in considering the industry environment, business growth characteristics, long-term financial plan, retention of talents and perpetual operation of business. Alpha considers the capital budget to determine the distribution of stock dividends, accompanied by cash dividends which should be no less than 10% of total dividends.

Information about directors' and supervisors' remuneration and employees' bonuses which were distributed from unappropriated earnings of 2003 is as follows:

Employees' bonuses—cash	\$ 5,150
Directors' and supervisors' remuneration	<u>824</u>
	<u>\$ 5,974</u>

Assuming that employees' bonuses and directors' and supervisors' remuneration were recognized as periodic expenses, the after-tax net income per common share for 2003 would be adjusted to \$0.20 (in New Taiwan dollars).

The actual distribution of employees' bonuses and directors' and supervisors' remuneration for 2004 is subject to the proposal of the board of directors and a resolution of the stockholders. Relevant information would be available on the Market Observation Post System of the Taiwan Stock Exchange after the above-mentioned meetings.

11. Income Taxes

- (1) In accordance with the Business Mergers and Acquisitions Act, D-Link separated its ODM/OEM operations from its D-Link brand business and transferred related operations' assets and liabilities to establish Alpha on August 16, 2003. The following income tax exemption and other tax benefits related to the ODM/OEM business division could be inherited by Alpha from August 16, 2003.

	<u>Duration of tax exemption</u>
2000 capital increase	January 1, 2001 ~ December 31, 2004
2001 capital increase	January 1, 2002 ~ December 31, 2005

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Alpha meets the requirements of "Important Strategic Industry" as prescribed by the Statute for Upgrading Industries, and is entitled to an income tax exemption on the profits generated from certain operations over a period of five years or a stockholders' investment tax credit. As of December 31, 2004, Alpha has not determined its tax incentive selection.

- (2) The income tax return of each consolidated entity is filed separately and could not be consolidated filing with Alpha. Alpha is subject to a maximum income tax rate of 25 percent. Alpha's subsidiaries are subject to the current tax rate of the countries in which they operate.

Income tax expense for 2004 consisted of the following:

	2004
Current	\$ 57,812
Deferred	(5,110)
Additional 10% income surtax on undistributed earnings	<u>13,520</u>
	<u>\$ 66,222</u>

- (3) The components of deferred income tax assets (liabilities) as of December 31, 2004, are summarized as follows:

	2004
Deferred tax assets—current:	
Investment tax credits	\$ 80,928
Employee benefits	1,500
Allowance for decline in value of inventories	21,837
Unrealized losses on exchange	2,378
Product warranty	31,485
Others	<u>12</u>
	138,140
Less: valuation allowance	<u>(85,000)</u>
Net current deferred tax assets	<u>\$ 53,140</u>

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

	2004
Deferred tax assets—noncurrent:	
Investment tax credits	45,000
Loss carryforward	9,883
Investment loss on long-term equity investments in foreign entities	3,755
Accrued pension cost	11,299
Employee benefits	6,000
Foreign currency translation adjustment	<u>1,091</u>
	77,028
Less: valuation allowance	<u>(45,000)</u>
	<u>\$ 32,028</u>
Total deferred tax liabilities	<u>\$ 215,168</u>
Valuation allowance for deferred tax assets	<u>\$ 130,000</u>

- (4) Alpha's investment credits from the purchase of machinery, research and development expenditure, and training expenditure under the ROC Statute for Upgrading Industries that can be utilized each year is limited to 50 percent of the year's current tax expense. However, the foregoing limit does not apply to the last year of the investment tax credit's expiration period. As of December 31, 2004, the unused investment tax credits and related expiration dates were as follows:

<u>Unused investment tax credit</u>	<u>Expiration date</u>
\$ <u>125,928</u>	2008

- (5) As of the December 31, 2004, the ROC income tax authorities had not been examined and assessed the income tax returns of Alpha for all fiscal years through December 31, 2004.
- (6) According to the ROC Income Tax Law, losses of Redsonic as assessed by the tax authorities can be carried forward to offset the future 5 years' taxable profits. As of December 31, 2004, Redsonic's unused loss carryforwards and related expiration dates were as follows:

<u>Amount</u>	<u>Expiration date</u>
\$ <u>39,531</u>	2009

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Information relating to the ICA of Alpha as of December 31, 2004, is summarized as follows:

	2004
Unappropriated retained earnings:	
Earned after December 31, 1997	\$ <u>740,246</u>
ICA balance	\$ <u>14,380</u>
Expected creditable ratio for earnings distribution to resident stockholders	10.85% (estimated)

12. Net Income per Common Share

	2004	
	Before taxes	After taxes
Basic net income per common share:		
Net income for 2004	\$ <u>771,243</u>	<u>705,021</u>
Weighted-average common shares outstanding (thousand shares)	<u>245,833</u>	<u>245,833</u>
Basic net income per common share (NT\$)	\$ <u>3.14</u>	<u>2.87</u>
Diluted net income per common share:		
Net income when calculating diluted EPS	\$ <u>771,243</u>	<u>705,021</u>
Weighted-average common shares outstanding (thousand shares)	245,833	245,833
Dilutive potential common shares (thousand shares)	<u>14,780</u>	<u>14,780</u>
Diluted weighted-average common shares outstanding (thousand shares)	<u>260,613</u>	<u>260,613</u>
Diluted net income per common share (NT\$)	\$ <u>2.96</u>	<u>2.71</u>

13. Financial Instruments

(1) Derivative financial instruments

Alpha used derivative financial instruments to hedge existing assets and liabilities denominated in foreign currencies. The counter-parties of the derivative contracts are reputable financial institutions. Therefore, management believes that the risk of default by the counter-parties is remote.

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(a) Nontrading-purpose derivative financial instruments

(i) Foreign currency option contracts

As of December 31, 2004, Alpha had the following foreign currency option contracts outstanding:

Contract	December 31, 2004 Contract Amount (in thousands)	Credit risk
Call option (sell)	USD31,000	-
Put option (sell)	USD 3,000	-

As of December 31, 2004, according to a ruling issued by the ROC ARDF, foreign currency option contracts that do not qualify as effective hedges are marked-to-market, with changes in value recognized in other unrealized income. Alpha did not recognize this gain based on the conservatism principle.

The realized gain resulting from foreign currency option contracts was \$3,877 thousand in 2004.

(ii) Forward foreign currency exchange contracts

As of December 31, 2004, the notional principal of outstanding forward foreign currency exchange contracts entered into was USD45,000 thousand. The details of the above forward foreign currency exchange contracts' balance as of December 31, 2004, are as follows:

	December 31, 2004
Forward foreign currency exchange contract receivables	\$ 1,463,270
Forward foreign currency exchange contract payables	(1,428,750)
Discount on forward foreign currency exchange contract	<u>(594)</u>
	<u>\$ 33,926</u>
Fair value	<u>\$ 30,420</u>

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES**Notes to Consolidated Financial Statements****(b) Fair value and risk****(i) Fair value and risk**

The fair value of derivative financial instruments represents the amount the Company may receive or paid if relevant contracts are settled at balance sheet date, which generally includes unrealized gain or loss. The Company determines the fair value on derivative financial instruments based on the quoted market price provided by financial institution.

(ii) Credit risk

Credit risk represents the accounting loss that would be recognized at the reporting date if counter-parties failed to perform as contracted. Credit risk will increase as the derivative instruments become more profitable. The Company entered into the above derivative contracts with reputable financial institutions. The likelihood of default on the part of the counter-parties is considered remote.

(iii) Market price risk

Market price risk represents the accounting loss that would be recognized at the reporting date for the derivative financial instruments due to changes in market interest rates or foreign exchange rates. As The Company derivative financial instruments are for hedging purposes, the gains or losses due to changes in the interest rates or foreign exchange rates will be naturally offset by the hedged items. As a result, market price risk is considered low.

(iv) Liquidity risk

Liquidity risk is the risk of being unable to settle derivative contracts on schedule. The purpose of these instruments held by The Company was to manage and hedge the floating interest rates and foreign currency exchange rates. There is no significant liquidity risk for the related cash flows.

The notional principals of the above derivative contracts were only reflected in the unsettled contracts. The fair value of the financial instruments disclosed herein is not necessarily representative of the potential gain or loss that could be realized under current credit and market price risks. The Company does not believe a significant loss on the above financial derivative contracts will occur.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(2) Non-derivative financial instruments

The Company's nonderivative financial assets include cash and cash equivalents, short-term investment, notes and accounts receivable, receivables from related parties, other financial assets, and long-term equity investments. The Company's nonderivative financial liabilities consist of short-term borrowings, accounts payable, and payables to related parties.

The following methods and assumptions were used to estimate the fair value of each class of non-derivative financial instruments:

- (a) The carrying amounts of cash and cash equivalents, notes and accounts receivable, other financial assets, accounts payable, payables to related parties, and short-term borrowings approximate their fair value due to the short-term nature of these items.
- (b) The fair value of short-term investments is based on publicly quoted market prices. Refer to note 4 for the fair value of short-term investments as of December 31, 2004.
- (c) It is not practicable to determine the fair value of long-term equity investments when these investments are not publicly traded. As of December 31, 2004, the cumulated investment costs of long-term equity investments amounted to \$16,985 thousand.

14. Related-party Transactions

- (1) The name and relationship of the related parties with which Alpha and its subsidiaries had significant transactions are shown below:

Name	Relationship
D-Link Corporation (D-Link)	Parent of Alpha
D-Link Systems, Inc. (DSI)	Subsidiary directly owned by D-Link
D-Link India Ltd. (DIL)	Investee accounted for under the equity method
D-Link Electronics Equipment (Shanghai) Co., Ltd. (DEECL)	An indirectly owned subsidiary of D-Link
Bothhand Enterprise Inc. (BEI)	Investee of D-Link accounted for under the equity method
Cameo Communications, Inc. (CCI)	Investee of D-Link accounted for under the equity method
Cellvision System Inc. (CSI)	Subsidiary indirectly owned by D-Link
D-Link Electronics (Wujiang) Co., Ltd. (DECL)	Subsidiary indirectly owned by D-Link

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

- (2) Significant transactions with related parties as of and for the year ended December 31, 2004, are summarized below:

(a) Sales

	2004	
	Amount	Percentage of net sales
D-Link	\$ 6,712,726	48
DEECL	1,646,616	12
CCI	107,145	1
CSI	59,956	-
Others	<u>16,703</u>	<u>-</u>
	<u>\$ 8,543,146</u>	<u>61</u>

The average credit terms extended to related parties and third-party customers were approximately 30-90 days.

(b) Purchases and others

	2004	
	Amount	Percentage of net purchases
BEI	\$ 93,610	1
D-Link	69,261	-
Others	<u>9,864</u>	<u>-</u>
	<u>\$ 172,735</u>	<u>1</u>

There are no significant differences in purchasing terms between related parties and third-party suppliers.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

The Company paid service fees to related parties for warranty services, advertising, and exhibitions. The total service fees for the year ended December 31, 2004, and the related unpaid balance as of December 31, 2004, are summarized below:

	2004	
	Current expense	Accrued expense
DSI	\$ 29,882	-
DIL	14,974	14,974
D-Link	7,511	-
	<u>\$ 52,367</u>	<u>14,974</u>

(c) Accounts receivable/payable

	December 31, 2004	
	Amount	Percentage
Accounts receivable:		
D-Link	\$ 1,419,711	52
DEECL	486,738	18
CSI	34,469	1
CCI	33,440	1
Others	4,538	-
	<u>\$ 1,978,896</u>	<u>72</u>

	December 31, 2004	
	Amount	Percentage
Accounts payable:		
BEI	\$ 27,585	2
Others	6,111	-
	<u>\$ 33,696</u>	<u>2</u>

The amount that the Company paid or received from D-Link was the balance after offsetting the receivables due from and the payables due to D-Link.

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) Acquisition of property, plant and equipment

	2004	
	Amount	Account payable
D-Link		
Machinery and mold	\$ 74,552	-
Research and development software	<u>78,370</u>	<u>-</u>
	152,922	-
DECL	21,206	21,206
Others	<u>5,925</u>	<u>4,147</u>
	<u>\$ 180,053</u>	<u>25,353</u>

As of December 31, 2004, the unrealized inter-company profits resulting from property, plant and equipment transactions amounted to \$59 thousand and were recorded as deferred inter-company profit.

(4) Others

- (a) During the normal courses of business, the Company paid on behalf of related parties, or vice versa. As of December 31, 2004, the resulted net receivable amounted to \$240 thousand, and was recorded as receivables from related parties.
- (b) In 2004, D-Link transferred the inventories belonging to its ODM/OEM operations to Alpha amounting to \$1,580,109 thousand.
- (c) Alpha entered into a service agreement with D-Link on December 25, 2003. Pursuant to this agreement, Alpha is obligated to provide services concerning information system maintenance and human resources. In 2004, the service income amounting to \$26,700 thousand had been received and was recorded as a reduction to service expenses.
- (d) Alpha entered into a plant lease agreement with D-Link for the plant located in the Hsin Chu Science Park. The duration of the plant lease agreement was from January to December 2004. The rental expenses amounting to \$12,000 thousand in 2004 and were full paid as of December 31, 2004.

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

15. Pledged Assets

Assets pledged as collateral as of December 31, 2004, are summarized as follows:

Pledged assets	Pledged to secure	December 31, 2004
Time deposit	Guarantees of import tax	\$ <u>4,000</u>

Alpha entered into an agreement with Chiao Tung Bank Hsin Chu Branch in 2004. Pursuant to this agreement, Alpha was provided a line of credit for customs guarantees of the Science Park amounting to \$500 thousand.

16. Commitments and Contingencies

(1) Major operating leases

Lease	Lessor	Description	Rental expense in 2004	Payment method
Land	Hsinchu Science Park	Nov. 2003~Dec. 2022	\$6,840 thousand	Monthly
Factory	D-Link	Jan. 2004~Dec. 2004	\$12,000 thousand	Monthly

- (2) Alpha entered into several royalty agreements with certain companies. According to these agreements, Alpha is obligated to pay royalties when Alpha sells products using the technologies specified in the royalty agreements. Total royalty expenses incurred under these agreements for the year ended December 31, 2004, amounted to \$12,745 thousand.
- (3) As of December 31, 2004, Alpha had provided guarantee notes amounting to \$4,207,700 thousand to financial institutions for bank loans and letters of credit.
- (4) According to D-Link's spin-off plan, unless the liabilities existing before the spin-off could be clearly separated, Alpha should take the joint and several responsibilities for discharging any liability that existed before the spin-off with D-Link based on Article 32 of the ROC Business Mergers and Acquisitions Act. However, the creditors' right to claim for the performance of the joint and several liabilities shall become extinguished if not exercised by the creditors within two years from the date of spin-off.

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ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

17. Other Information

The information on labor, depreciation, and amortization expenses by function for the year ended December 31, 2004, is summarized as follows:

Account	Cost of goods sold	2004 Operating expense	Total
Employee expenses:			
Salaries	390,329	609,871	1,000,200
Labor and health insurance	27,157	45,517	72,674
Pension	14,550	31,137	45,687
Others	20,440	43,098	63,538
Depreciation	122,435	180,482	302,917
Amortization	2,163	118,173	120,336

18. Segment Financial Information

(1) Industry information

The Company principally operates in one industry segment: network communication products.

(2) Geographic information

The geographical breakdown of sales for the year ended December 31, 2004, is summarized as follows:

	Asia	Americas	2004 Adjustments and eliminations	Total
Area revenue:				
Third-party customers	\$ 14,082,845	-	-	14,082,845
Inter-company	352,510	46,895	(399,405)	-
	<u>\$ 14,435,355</u>	<u>46,895</u>	<u>(399,405)</u>	<u>14,082,845</u>
Area profit before taxes	<u>\$ 720,571</u>	<u>2,160</u>	<u>48,512</u>	<u>771,243</u>
Area identifiable assets	<u>\$ 8,063,540</u>	<u>22,826</u>	<u>(249,226)</u>	<u>7,837,140</u>

(Continued)

ALPHA NETWORKS INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) Export sales

The export sales of consolidated entities located in the ROC for the year ended December 31, 2004, are summarized below:

	2004	
	Amount	Percentage of net sales
Asia	\$ 5,258,187	38
Americas	2,735,472	19
Europe	1,774,896	13
Others	<u>753,257</u>	<u>5</u>
	<u>\$ 10,521,812</u>	<u>75</u>

(4) Major customers

Individual customer represents greater than 10% of consolidated revenue in 2004 are as follows:

	2004	
	Amount	Percentage of net sales
D-Link	\$ 6,712,726	48
DEECL	<u>1,646,616</u>	<u>12</u>
	<u>\$ 8,359,342</u>	<u>60</u>