

## Operating and financial review

### Important note

This discussion and analysis of our consolidated financial condition and results of operations should be read in conjunction with our audited consolidated financial statements and other financial information included elsewhere in this annual report. Our audited consolidated financial statements have been prepared on the basis of a number of assumptions more fully explained in Note 1 (Description of Business, Formation and Basis of Presentation) and Note 2 (Summary of Significant Accounting Policies) to our audited consolidated financial statements appearing elsewhere in this annual report.

### OVERVIEW OF THE 2005 FINANCIAL YEAR

In our 2005 financial year, which ended September 30, the global economy was generally weaker than in the prior year and the semiconductor market experienced a period of growth moderation. As a global player on the semiconductor market, we were impacted by these unfavorable global economic and market conditions, especially by strong pricing pressure as well as by a decreased demand in our operating segments. In order to address the current challenges in the semiconductor market, we simplified our organization to create shorter and faster decision paths across the entire Company, a stronger customer orientation, as well as greater efficiency and flexibility. We also integrated a number of centralized functions such as sales and manufacturing into the operating segments. In addition, we reached significant milestones in our joint manufacturing ventures and the development of new product technologies.

The following were the key developments in our business during the 2005 financial year:

- The Mobile business and Wireline Communication segment were combined into the new Communication segment to align our structure with market developments. At the same time, the security and chip card activities and the ASIC & Design Solutions business were integrated into the extended Automotive, Industrial and Multimarket segment.
- Our revenues decreased by 6.1 percent, from €7,195 million in the 2004 financial year to €6,759 million in the 2005 financial year. Our earnings before interest and taxes (EBIT) decreased from positive €256 million in the 2004 financial year to negative EBIT of €183 million in the 2005 financial year.
- Our cash flow from operations decreased from €1,857 million in the 2004 financial year to €1,039 million in the 2005 financial year. The reduction was due mainly to decreased gross margin and changes in various current liabilities.
- We and ProMOS Technologies Inc. ("ProMOS") reached an agreement regarding ProMOS' license of our previously transferred technologies, pursuant to which ProMOS may continue to produce and sell products using those technologies and to develop its own processes and products. As full consideration, ProMOS agreed to pay us \$156 million in four installments through April 30, 2006. The parties agreed to withdraw their respective claims.

- We consummated the acquisition of Saifun Semiconductors Ltd.'s ("Saifun") remaining 30 percent share in the Infineon Technologies Flash joint venture. As part of this acquisition, Saifun granted us a license for the use of Saifun NROM® technologies.
- We sold certain assets of our fiber optics business to Finisar Corporation ("Finisar") in exchange for 34 million shares of Finisar's common stock, which were subsequently sold.
- We sold our interest in Infineon Ventures GmbH, including the majority of the venture investments held therein.
- We and Rambus Inc. ("Rambus") reached an agreement settling all claims between us and providing for a worldwide license to us of the Rambus patent portfolio for use in our current and future memory products.
- We agreed upon restructuring measures aimed at reducing costs, downsizing our workforce, and consolidating certain functions and operations. In connection with these measures, restructuring charges of €78 million were recognized during the 2005 financial year.
- We recognized impairment charges of €134 million in the 2005 financial year, principally related to our remaining fiber optics businesses, the reorganization measures within our Communication segment and long-term investments.
- We continued to invest heavily in research and development and achieved a number of significant milestones during the year, including the introduction of:
  - E-GOLDradio, the latest member of our successful E-GOLD family, integrating the complete functionality of our base-band chip, E-GOLDlite, and our sophisticated quadband RF transceiver, SMARTi SD2;
  - 90-nanometer DRAM trench technology and demonstration of first functional parts on 70-nanometer DRAM trench technology;
  - VINAX, our new VDSL2 chip solution, designed for applications ranging from low-end modems to high-end home gateways;
  - SMARTi 3G, the latest member of our successful UMTS transceiver family, designed to be used in mobile applications and supporting currently specified UMTS bands I through VI worldwide;
  - a new 8/16/32 bit microcontroller with embedded Flash for use in industrial and automotive applications;
  - the new space-saving production method FCOS (Flip Chip On Substrate) developed jointly with Giesecke & Devrient GmbH ("Giesecke & Devrient"); and
  - a new Trusted Platform Module (TPM), a complete independent hardware and software solution according to the specification of Trusted Computing Group.
- As part of our ongoing project to improve our production processes and expand our production capabilities, we:
  - successfully transferred to different production facilities our high-performance process technology using structure sizes of 130-nanometer for logic products, in order to further increase our production flexibility;
  - successfully introduced the 90-nanometer process technology for DRAM products in our 300-millimeter production facility at Dresden;
  - expanded the scope of our joint development agreement with Nanya Technology Corporation ("Nanya") to include next generation 60-nanometer DRAM trench technology;
  - saw our joint venture Inotera ramp up to approximately 60,000 wafer starts per month several months ahead of schedule;
  - saw the 300-millimeter facilities at our plant in Richmond, Virginia, and at our foundry partner Semiconductor Manufacturing International Corporation ("SMIC") in Beijing, China, start commercial production;
  - started manufacturing at our memory chip assembly and testing facilities in Suzhou, China;
  - started the construction of a new front-end production plant in Kulim High Tech Park, Malaysia, with a total planned investment of approximately \$1 billion. The facility will mainly produce power and logic chips used in automotive and industrial power applications; and
  - formed a new development center in Bucharest, Romania, with a principal focus on power ICs including analog and digital functions.

## OUR BUSINESS

We design, develop, manufacture, and market a broad range of semiconductors and complete systems solutions used in a wide variety of microelectronic applications, including computer systems, telecommunications systems, consumer goods, automotive products, industrial automation and control systems, and chip card applications. Our products include standard commodity components, full-custom devices, semi-custom devices, and application-specific components for memory, analog, digital, and mixed-signal applications. We have operations, investments, and customers located mainly in Europe, Asia, and North America.

Following our internal reorganization in the 2005 financial year, our business is organized into three principal operating segments serving various markets in the semiconductor industry:

- Our Automotive, Industrial and Multimarket segment designs, develops, manufactures, and markets semiconductors and complete system solutions for use in automotive, industrial, and multimarket applications.
- Our Communication segment designs, develops, manufactures, and markets a wide range of ICs, other semiconductors, and complete system solutions for wireline and wireless communication applications.
- Our Memory Products segment designs, develops, manufactures, and markets semiconductor memory products with various packaging and configuration options and performance characteristics for standard, specialty, and embedded memory applications.

We have two additional segments for reporting purposes, our Other Operating Segments, which includes remaining activities for certain product lines that we have disposed of, as well as other business activities, and our Corporate and Reconciliation segment, which contains items not allocated to our operating segments, such as certain corporate headquarters' costs, strategic investments, unabsorbed excess capacity, restructuring costs, and corporate IT development expenses.

## THE SEMICONDUCTOR INDUSTRY AND FACTORS THAT IMPACT OUR BUSINESS

Our business and the semiconductor industry are highly cyclical and are characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. Although these factors affect all segments of our business, they are especially pronounced in our Memory Products segment, are increasingly true of our Communication segment, and have the least impact on our Automotive, Industrial and Multimarket segment.

### Cyclicality

The industry's cyclicality results from a complex set of factors, including, in particular, fluctuations in demand for the end products that use semiconductors and fluctuations in the manufacturing capacity available to produce semiconductors. This cyclicality is especially pronounced in the memory portion of the industry. Semiconductor manufacturing facilities (so-called fabrication facilities, or "fabs") can take several years to plan, construct, and begin operations. Semiconductor manufacturers have in the past made capital investments in plant and equipment during periods of favorable market conditions, in response to anticipated demand growth for semiconductors. If more than one of these newly built fabs comes on-line at about the same time, the supply of chips to the market can be vastly increased. Without sustained growth in demand, this cycle has typically led to manufacturing overcapacity and oversupply of products, which in turn has led to sharp drops in semiconductor prices. When prices drop, manufacturers have in the past cut back on investing in new fabs. As demand for chips grows over time, without additional fabs coming on line, prices tend to rise, leading to a new cycle of investment. The semiconductor industry has generally been slow to react to declines in demand, due to its capital-intensive nature and the need to make commitments for equipment purchases well in advance of planned expansion.

We attempt to mitigate the impact of cyclicality in the memory business by investing in our manufacturing capacities throughout the cycle and entering into alliances and foundry manufacturing arrangements that provide flexibility in responding to changes in the cycle. We believe that we can improve our gross margin in the memory business by focusing on two key areas: the continuous improvement of cost structure and productivity through the introduction of advanced memory process technologies and the development and marketing of a broader

range of memory products, focusing particularly on higher margin and less volatile applications such as infrastructure, high-end graphics, consumer and mobile applications.

### Substantial capital and R&D expenditures

Semiconductor manufacturing is very capital-intensive. The manufacturing capacities that are essential to maintain a competitive cost position require large investments in manufacturing assets. The top 10 capital spenders in the industry, of which we rank number 8 according to IC Insights, account for more than 50 percent of the industry's average capital expenditure. Manufacturing processes and product designs are based on leading-edge technologies that require considerable research and development expenditures. A high percentage of the cost of operating a fab is fixed; therefore, increases or decreases in capacity utilization can have a significant effect on profitability.

Because pricing, for DRAM products in particular, is market-driven and largely beyond our control, a key factor for us in achieving and maintaining profitability is to continually lower our per-unit costs by reducing our total costs and by increasing unit production output.

To reduce our total costs, we also aim to share the costs of research and development and manufacturing facilities with third parties, either by establishing alliances or through the use of foundry facilities for manufacturing. We believe that cooperation in alliances for R&D and manufacturing and foundry partnerships provide us with a number of important benefits, including the sharing of risks and costs, reducing our own capital requirements, allowing us to develop a broader range of products, acquiring technical know-how, and gaining access to additional production capacities. We are developing future DRAM technologies with feature sizes of 70-nanometer and 60-nanometer together with Nanya. In addition, we have established foundry relationships with partners in Asia, including SMIC and Winbond Electronics Corp., Hsinchu, Taiwan ("Winbond"), to increase our manufacturing capacities, and therefore our potential revenues, without investing in additional manufacturing assets. In our logic area, our principal alliances are with International Business Machines Corporation ("IBM"), Chartered Semiconductor Manufacturing Ltd. ("Chartered Semiconductor"), and Samsung Electronics Co. Ltd. ("Samsung") for CMOS development and manufacturing at 65-nanometer and 45-nanometer process technologies, with United Micro-

electronics Corporation ("UMC") for 90-nanometer manufacturing, and with IBM through our manufacturing joint venture ALTIS Semiconductor S.N.C. ("ALTIS") in Essonnes, France.

We expect to increase unit production output through improvements in manufacturing, which is achieved by producing chips with smaller structure sizes (more bits per chip) and by producing more chips per silicon wafer (by using larger wafers). For DRAM process technology, the majority of our capacity is based on 110-nanometer structure sizes. In addition we have started commercial production based on 90-nanometer structure sizes, jointly developed with Nanya. We have extended our 300-millimeter capacity share during the 2005 financial year with the continuous ramp up of our joint venture with Nanya, Inotera, and the start of ramp-up of foundry capacities at SMIC in Beijing and our own facility in Richmond. We plan to further extend the share of our memory production on 300-millimeter wafers with the continuous ramp-up of our 300-millimeter line in Richmond and the additions of capacities at our foundry partner Winbond in the 2006 financial year. In our logic area, the majority of our capacity is based on 130-nanometer structure sizes. Our 130-nanometer logic process technology, with up to eight layers of copper metallization, is in full production at several manufacturing sites, including our Dresden facility and our manufacturing joint venture with IBM in Essonnes, France. We are currently in the process of ramping up production of several products using our 90-nanometer logic technology and have also begun qualification of our 65-nanometer logic process technology.

### Technological development and competition

Sales prices per unit are volatile and generally decline over time due to technological developments and competitive pressure. Memories in particular are commodity-type products. Since most specifications are standardized, customers can switch between suppliers on short notice. This leads to strong competition within the market, and causes manufacturers to pass cost savings on to their customers in an effort to gain market share. Logic products are generally not commodities, but rather have a certain degree of application specification. Although generally less volatile than those for commodity memory products, unit sales prices for logic products typically decline over time as technological developments occur.

We aim to offset the effects of declining unit sales prices on total revenues by optimizing product mix, and by increasing unit sales volume and residual effects on gross margin by continually reducing per-unit production costs. The growth in

volumes depends in part on productivity improvements in the manufacturing of semiconductor chips. By moving to ever-smaller structure sizes in manufacturing, the number of functional elements has historically doubled approximately every two years. This trend, often called Moore's Law, has led to an average growth rate of bit-volumes of between 40 percent and 45 percent per year and, assuming constant costs per square inch of silicon, to an approximately 30 percent cost reduction per bit per year.

### Seasonality

Our business is affected by seasonality, with sales historically stronger in our fourth financial quarter and weaker in our first and second financial quarters. The seasonality of our sales reflects the seasonal demand fluctuations for the products that incorporate our semiconductors. If anticipated sales or shipments do not occur when expected, expenses and inventory levels in that quarter can be disproportionately high, and our results of operations for that quarter, and potentially for future quarters, may be adversely affected.

### Product development cycles

For logic products, the cycle for test, evaluation, and adoption of our products by customers before the start of volume production can range from several months to more than one year. Due to this lengthy cycle, we may experience significant delays from the time we incur expenses for research and development, marketing efforts, and investments in inventory, to the time we generate corresponding revenue, if any. Development cycles affect memory products to a lesser extent due to the higher degree of standardization for memory products.

### Acquisition and divestiture strategy

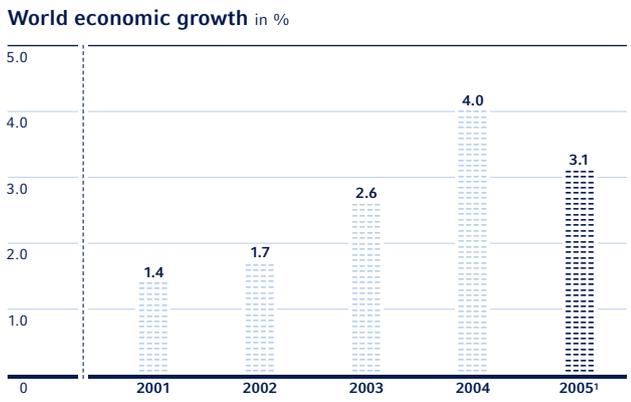
A key element of our business strategy involves the acquisition and divestiture of businesses, assets, products, or technologies to reduce the time required to develop new technologies and products and bring them to market, and to optimize our existing product offerings, market coverage, engineering workforce, or technological capabilities. We plan to continue to evaluate strategic opportunities as they arise, including business combination transactions, strategic relationships, capital investments, and the purchase or sale of assets.

### Intellectual Property

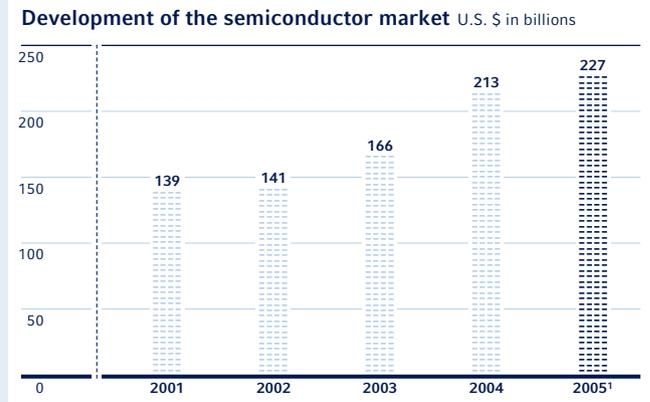
Due to the high-technology nature of the semiconductor industry, Intellectual Property (IP), meaning intangible assets relating to proprietary technology, is of significant importance. Companies that have their own patented IP often allow third parties to use their IP in exchange for license fees. It can be costly and difficult to defend against infringement by third parties, or to defend the Company against claims by third parties of infringement of their technology. We do not record assets in our balance sheet for self-developed IP. Only IP licensed from others or acquired through a business acquisition is reflected on our balance sheet, and reduced through amortization over its expected useful life. The value of such acquired IP is often complex and difficult to estimate.

### CHALLENGES THAT LIE AHEAD

Going forward, our success will remain highly dependent on our ability to stay at the leading edge of technology development, and to continue to optimize our product portfolio. We must achieve both objectives to ensure that we have the flexibility to react to fluctuations in market demand for different types of semiconductor products. We believe that the ability to offer and flexibly manufacture a broad portfolio of products will be increasingly important to our long-term success in many markets within the semiconductor industry. Establishing and maintaining advantageous technology, development and manufacturing alliances, including the use of third-party foundries, and continuing our efforts to broaden our product portfolio will make it easier for us to respond to changes in market conditions and to improve our financial performance.



The growth slowdown of the world economy in the 2005 calendar year did not have a positive influence on semiconductor market growth.  
Source: International Monetary Fund; status: September 2005.  
1 Estimated.



Growth slowdown of the semiconductor market in the 2005 calendar year negatively impacted Infineon.  
Source: WSTS; status: October 2005.  
1 Estimated.

### SEMICONDUCTOR MARKET CONDITIONS IN THE 2005 FINANCIAL YEAR

The growth of the semiconductor market weakened significantly during the 2005 calendar year following growth of 28 percent in the 2004 calendar year, according to WSTS (World Semiconductor Trade Statistics). In October 2005, WSTS predicted a growth rate of 7 percent for the 2005 calendar year. According to WSTS, sales in the Asia-Pacific region are expected to increase by 16 percent in the 2005 calendar year. The semiconductor market in Japan is expected to decrease slightly by 3 percent; the European market is expected to remain stable; the North American market is expected to increase slightly by 2 percent. Sales of non-memory products (logic chips, analog, discrete, and optical components), which accounted for 79 percent of the entire market in the first half of the 2005 calendar year, are predicted to grow by 8 percent compared with the 2004 calendar year. Sales of memory products are predicted to grow by 3 percent compared with the 2004 calendar year.

Gartner Dataquest predicts worldwide growth in the 2005 calendar year of 5 percent for semiconductors in the communications business (wireless and wireline). Sales of semiconductors for data processing are predicted to grow by 7 percent, for consumer electronics by 12 percent and for automotive electronics by 7 percent.

### PLANS FOR A NEW SET-UP OF OUR COMPANY

Our key objective is to achieve profitable growth and to maximize value for our shareholders. As such, we regularly consider appropriate steps towards these aims. In furtherance of these goals, and following extensive analysis of our markets and our business, in November 2005 our Supervisory Board approved a plan to restructure our Company in order to better prepare us to exploit market opportunities for our memory products and logic businesses as and when they arise.

The first step in this process will be a transfer of all the assets and liabilities of our Memory Products segment into a separate, wholly owned subsidiary of Infineon (this "drop-down" of assets and liabilities, or "Teilbetrieb", is known as an "Ausgliederung" under German law).

We believe that these reorganization measures will position us quickly to take advantage of appropriate market opportunities for the memory business as and when they arise. We intend to monitor and evaluate financial and industry developments continuously during the 2006 financial year and will consider further reorganization steps as appropriate. It is our Management Board's preferred option to reinforce the market position of the memory products group through an initial public offering (IPO) of shares in the new legal entity. Nevertheless, we have not yet decided on any specific steps following the drop-down of assets and liabilities or any specific timeframe for such steps. We would, over the medium to long term, also consider reducing our position in the current Memory Products group to a minority stake.

## Background

Our business includes both the memory semiconductor activities of our Memory Products segment and the logic semiconductor activities of our two applications segments, Automotive, Industrial and Multimarket, and Communication. The memory and logic sides of our business have historically benefited from certain synergies, but we believe that the two lines of business will diverge in significant respects, reflecting differences in both technological innovation and economics, and that these synergies will therefore decrease. In particular, the memory business continues to be characterized by a highly capital-intensive drive to continuously update and improve manufacturing processes and cost position. The logic business, on the other hand, is evolving into an application/solution-driven model, which requires continuous product development and specialized manufacturing. The intense capital demand of the memory business reflects the need to invest continuously in very costly, efficient and up-to-date fabrication facilities and leading-edge manufacturing technologies. The logic business operates on a smaller manufacturing scale. Certain parts of it (our "advanced logic business" consisting mainly of mobile phone baseband ICs and a range of chip card, wired communication, microcontroller, and other customer-specific ICs) are well-prepared to make use of foundry manufacturing capacity for standard semiconductor manufacturing processes (so-called CMOS technology). Certain other parts of it, mainly our power and RF-IC businesses, can rely on sophisticated, significantly less capital-intensive manufacturing processes mastered in-house as an important competitive differentiator. In addition, the technologies employed in the two lines of business are expected to increas-

ingly diverge, resulting among other things in differing development roadmaps – with memory disproportionately focused on process technologies – and the need for strategic and development alliances with different partners. The synergies in design methodologies and tools are likewise becoming very limited. Finally, the two lines of business are subject to very different financial market dynamics – which may be less than fully transparent to investors in the combined business.

## RESULTS OF OPERATIONS

### Reorganization

Until the end of the first quarter of the 2005 financial year we were organized into four principal segments, three of which were application-focused – Wireline Communications, Secure Mobile Solutions and Automotive & Industrial; and one of which was product-focused – Memory Products. Beginning with the second quarter of the 2005 financial year, we simplified our organization to create shorter and faster decision paths across the entire Company, a stronger customer orientation, as well as greater efficiency and flexibility. The Mobile business and Wireline Communications segment were combined into the new Communication segment to align the Company's structure with market developments. At the same time, the security and chip card activities and the ASIC & Design Solutions business were integrated into the extended Automotive, Industrial and Multimarket segment.

Consequently, we are now organized into three principal segments, two of which are application-focused – Automotive,

### Results of Operations expressed as percentages of net sales

For the years ended September 30 <sup>1</sup>	2003	2004	2005
Net sales	100.0	100.0	100.0
Cost of goods sold	(75.0)	(64.9)	(72.6)
<b>Gross margin</b>	<b>25.0</b>	<b>35.1</b>	<b>27.4</b>
Research and development expenses	(17.7)	(16.9)	(19.1)
Selling, general, and administrative expenses	(11.0)	(10.0)	(9.7)
Restructuring charges	(0.5)	(0.2)	(1.2)
Other operating expense, net	(1.4)	(3.6)	(1.4)
<b>Operating income (loss)</b>	<b>(5.6)</b>	<b>4.4</b>	<b>(4.0)</b>
Interest expense, net	(0.8)	(0.6)	(0.1)
Equity in earnings (losses) of associated companies	0.3	(0.2)	0.9
Gain (loss) on associated company share issuance	(0.0)	0.0	0.0
Other non-operating income (expense), net	0.3	(0.9)	0.4
Minority interests	0.1	0.3	0.0
<b>Income (loss) before income taxes</b>	<b>(5.7)</b>	<b>3.0</b>	<b>(2.8)</b>
Income tax expense	(1.4)	(2.1)	(1.8)
<b>Net income (loss)</b>	<b>(7.1)</b>	<b>0.9</b>	<b>(4.6)</b>

<sup>1</sup> Columns may not add due to rounding.

Industrial and Multimarket, and Communication; and one of which is product-focused – Memory Products. These groups design, develop, manufacture, and market a broad range of semiconductors and complete system solutions used in a wide variety of microelectronic applications.

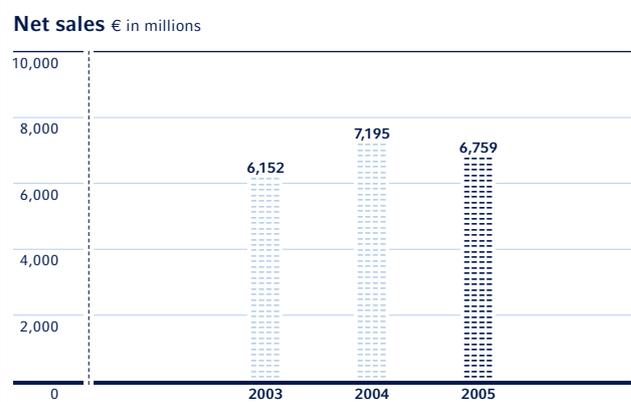
The Company reported its results of operations under this new organizational structure starting with the second quarter of the 2005 financial year. The results of operations of all periods presented have been reclassified to be consistent with the revised reporting structure and presentation, as well as to facilitate analysis of current and future operating segment information.

### Net sales

We generate our revenues primarily from the sale of our semiconductor products and systems solutions. In addition, we also generate less than 4 percent of our sales from activities such as foundry services for divested businesses and the licensing of our intellectual property. Our semiconductor products include two main categories of semiconductors:

- Our logic products, which include a wide array of chips and components used in electronic applications ranging from wireless communication devices (such as mobile phones and Bluetooth devices), chip cards, modems, and other wireline technologies such as DSL, automotive electronics, and industrial applications.
- Our memory products, such as dynamic random access memory (DRAM) products, which are used in computers and other electronic devices. We also offer a limited range of non-volatile flash memory products, which are used in consumer applications such as digital still cameras or mobile handsets.

We make the vast majority of our product sales through our direct sales force, with approximately 14 percent of our total revenue in any period derived from sales made through distributors.



Strong pricing pressure in all segments contributed to the decrease in net sales in the 2005 financial year.

We derive our license revenue from royalties and license fees earned on technology that we own and license to third parties. This enables us to recover a portion of our research and development expenses, and also often allows us to gain access to manufacturing capacity at foundries through joint licensing and capacity reservation arrangements. We recognize license income, primarily in the Memory Products segment, resulting from the transfer of technology to our current and former alliance partners, such as Winbond, Nanya, and ProMOS.

Our revenues fluctuate in response to a mix of factors, including the following:

- the market prices for our products, particularly our memory products;
- our overall product mix and sales volumes;
- the stage of our products in their respective life cycles; and
- the effects of competition and competitive pricing strategies.

For the years ended September 30	2003	2004	2005
<b>Net sales</b>	6,152	7,195	6,759
Changes year-on-year		17 %	(6 %)
of which:			
License income € in millions	183	76	175
% of net sales	3 %	1 %	3 %
Effect of foreign exchange over prior year € in millions	(317)	(445)	(177)
% of net sales	(5 %)	(6 %)	(3 %)
Impact of acquisitions over prior year € in millions	126	29	2
% of net sales	2 %	0 %	0 %

The increase in net sales in the 2004 financial year was mainly driven by higher demand for memory products and semiconductors used in mobile phones, as well as the continued strong performance of the Automotive, Industrial and Multimarket segment. In the 2005 financial year, net sales decreased primarily due to lower demand for products of the wireless business and declining prices for DRAM products. License income decreased in the 2004 financial year mainly as a result of a reduction in license revenues from ProMOS. In the 2005 financial year, license income increased primarily due to the settlement reached with ProMOS, whereby €118 million in license income was recognized. The decline of major foreign currencies (primarily the U.S. dollar) relative to the euro during the 2003, 2004, and 2005 financial years negatively impacted reported sales. The effect of foreign exchange over the prior year is calculated as the estimated change in current year sales if the average exchange rate for the preceding year is applied as a constant rate in the current year. The increase in revenues from entities we acquired since the beginning of the prior year reflects primarily the inclusion of a full-year consolidation of sales in the year after the initial acquisition.

Quarterly net sales € in millions



Sales increased in the fourth quarter of the 2005 financial year as a result of higher volumes.

## Net sales by segment

### --- Automotive, Industrial and Multimarket

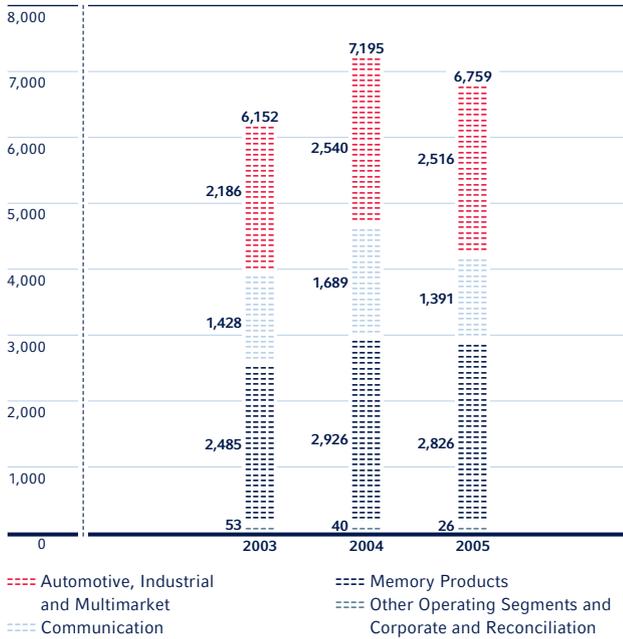
The segment experienced continued growth in the 2004 financial year as volume growth, particularly for automotive power applications (reflecting the increasing semiconductor content in automotive electronics), more than offset ongoing price pressure caused by technological developments and competition. Increased net sales in the 2004 financial year also resulted from higher volume sales of automotive and industrial products, and from increased demand for chip card and security products. We experienced price pressure in the market for chip card ICs throughout the 2003 financial year, while revenue in the 2004 financial year benefited from a slower rate of price decline. Sales in the 2004 financial year also benefited from the full-year consolidation of SensoNor AS ("SensoNor"), acquired in June 2003, and accelerated growth for industrial applications in the second half of the 2004 financial year. In the 2005 financial year, revenues in this segment decreased slightly compared to the 2004 financial year, despite a continued volume increase in the automotive business. The revenue decline was primarily due to strong pricing pressure combined with decreased market volumes in the security and chip card business.

### --- Communication

In the 2003 financial year and the first half of the 2004 financial year, we experienced increasing demand for digital access products as the need for DSL Internet-based communication increased, and markets in developing countries improved. An offsetting trend was the decrease in demand for traditional analog communication products, which was more pronounced in the second half of the 2004 financial year than in prior periods. Sales growth in the 2004 financial year occurred primarily in the second half of the year, as demand for mobile solutions accelerated. In the 2005 financial year, sales in the Communication segment declined year-on-year due to a revenue decrease in the wireless business, primarily caused by a decline in demand from some customers for baseband components beginning in the second quarter of the 2005 financial year, as well as continued pricing pressure. This decline could not be offset by the stable sales trend in the wireline business.

For the years ended September 30	2003		2004		2005	
	€ in millions	%	€ in millions	%	€ in millions	%
Automotive, Industrial and Multimarket	2,186	36	2,540	35	2,516	37
Communication	1,428	23	1,689	24	1,391	21
Memory Products	2,485	40	2,926	41	2,826	42
Other Operating Segments	21	-	11	-	12	-
Corporate and Reconciliation	32	1	29	-	14	-
<b>Total</b>	<b>6,152</b>	<b>100</b>	<b>7,195</b>	<b>100</b>	<b>6,759</b>	<b>100</b>

Net sales by segment € in millions



Net sales in our segments were significantly impacted by pricing pressure and the decrease in demand in the wireless communication business.

--- Memory Products

The increase in net sales in the 2004 financial year was due mainly to higher volumes, which more than offset the impact of an unfavorable U.S. dollar/euro exchange rate and lower license income. Sales volumes in the 2004 financial year also benefited from the ramp-up of our Dresden 300-millimeter facility, from the conversion to 110-nanometer technology and from access to additional capacity made available through our cooperation with Winbond and SMIC, which offset the reduced volume of products we purchased from ProMOS. Overall megabit volume increased during the 2004 financial year as a result of increasing market demand for personal computers and system memory. Net sales in the 2005 financial year declined compared to the previous year mainly due to price pressure, especially in the first half of the financial year, which could not be compensated by increasing bit shipments and increased revenues from licenses and Flash memory products. In addition, the continued unfavorable U.S. dollar/euro exchange rate further contributed to the revenue decline. Production volumes increased during the 2005 financial year primarily as a result of the ramp-up of our manufacturing joint venture Inotera and the access to additional capacity through our cooperation with Winbond and SMIC. Overall,

DRAM price development per 256-Mbit-equivalent in U.S.\$



Source: WSTS

megabit sales volume increased during the 2005 financial year as a consequence of increasing market demand, particularly for personal computers and system memory. The majority of our memory products sales were based on 256-Mbit DRAMs in the first half of the 2005 financial year and of 512-Mbit DRAMs in the second half of the 2005 financial year, as the market shifted to the next higher-density product generation.

The prices in U.S. dollars of both major products DDR and DDR2 memory ICs, declined sharply during the 2005 financial year, especially during the seasonally weaker period between January and April. After April, DDR prices stabilized, whereas DDR2 prices remained under pressure as a result of a supply overhang and slower than expected conversion to DDR2 as mainstream memory. Both contract and spot prices followed a similar trend. Per-bit prices for lower-density SDRAM products declined during the financial year as well, but remained at a higher level compared to DDR and DDR2 due to their legacy character. We plan to diversify our product portfolio and to optimize our product mix to take advantage of market price differentials, and especially increase our focus on products for server, consumer, high-end graphics, and mobile applications, which we believe offer less price volatility and higher margins. Our average per-megabit selling prices for DRAM products declined approximately 27 percent in the 2005 financial year.

--- Other Operating Segments

Net sales remained relatively unchanged in the 2005 financial year.

### Net sales by region and customer

Our sales decreased in the 2005 financial year in all major regions, primarily due to pricing pressure and a lower demand for semiconductor products, especially for baseband components in the wireless business in Germany.

In the Communication segment, we have seen a further consolidation in the industry. In the 2005 financial year, the largest original equipment manufacturers for mobile phones won market share at the expense of some other manufacturers. With

the acquisition of the Siemens Mobile Phone Division by BenQ Corporation ("BenQ"), a Taiwan-based company, we expect that a share of the production volume of one of our largest customers for mobile phone platforms will be shifted to manufacturing sites in Asia and other emerging markets, which have lower production costs. The number of customers of our Automotive, Industrial and Multimarket segment remained stable. In the 2005 financial year, our top 20 customers accounted for nearly 60 percent of that segment's sales. We experienced a shift of revenues from Germany to other European countries, especially to Eastern Europe, in connection with a shift of production facilities of our customers due to lower manufacturing costs in these regions. The number of Memory Product customers increased as we continued to diversify our product portfolio. In the 2005 financial year our top 20 customers accounted for nearly 80 percent of that segment's sales.

The Siemens group accounted for 14 percent, 13 percent, and 13 percent of our net sales in the 2003, 2004, and 2005 financial years, respectively. Sales to the Siemens group comprise both direct sales (which accounted for 13 percent, 13 percent, and 12 percent of net sales, respectively, in those financial years) and sales designated for resale to third parties (which accounted for 1 percent, 0 percent, and 1 percent of net sales, respectively, in those financial years). Sales to the Siemens group are made primarily by our logic application segments. No other single customer accounted for 10 percent or more of our net sales in the 2003, 2004, or 2005 financial years. Effective October 1, 2005, the Siemens Mobile Phone Division was sold to BenQ, a Taiwanese company. Although we still expect Siemens to be one of our largest customers in the 2006 financial year, we do expect that overall sales volumes with Siemens will significantly decline due to the sale of this division.



Shift of sales from Germany to other European countries.

### Net sales by region

For the years ended September 30	2003		2004		2005	
	€ in millions	%	€ in millions	%	€ in millions	%
Germany	1,535	25	1,675	23	1,354	20
Other Europe	1,112	18	1,263	18	1,210	18
North America	1,393	23	1,524	21	1,504	22
Asia-Pacific	1,821	29	2,263	32	2,223	33
Japan	256	4	364	5	332	5
Other	35	1	106	1	136	2
<b>Total</b>	<b>6,152</b>	<b>100</b>	<b>7,195</b>	<b>100</b>	<b>6,759</b>	<b>100</b>

### Cost of goods sold and gross margin

Our cost of goods sold consists principally of:

- direct materials, which consist principally of raw wafer costs;
- labor costs;
- overhead, including maintenance of production equipment, indirect materials, utilities, and royalties;
- depreciation and amortization;
- subcontracted expenses for assembly and test services;
- production support, including facilities, utilities, quality control, automated systems, and management functions; and
- foundry production costs.

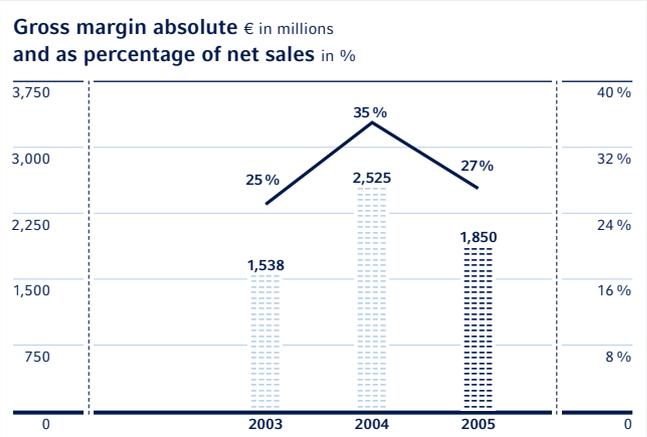
In addition to factors that affect our revenue, our gross margin is impacted by:

- factory utilization and related idle capacity costs;
- amortization of purchased intangible assets;
- product warranty costs;
- provisions for excess or obsolete inventories; and
- government grants, which are recognized over the remaining useful life of the related manufacturing assets.

We report as cost of goods sold the cost of inventory purchased from our joint ventures and other associated and related companies such as ALTIS, Inotera, and, through January 1, 2003, ProMOS. Our purchases from these affiliated entities amounted to €615 million in the 2005 financial year, €357 million in the 2004 financial year, and €470 million in the 2003 financial year.

For the years ended September 30	2003	2004	2005
Cost of goods sold € in millions	4,614	4,670	4,909
Changes year-on-year		1%	5%
% of net sales	75%	65%	73%
Gross margin	25%	35%	27%

The gross margin improvement during the 2004 financial year was attributable to a variety of factors, including improved integration and higher capacity utilization in most of our operating segments, a substantially improved cost position in our Memory Products segment, and a better overall pricing environment than in the prior financial year. Our gross margin deteriorated in the 2005 financial year, primarily as a result of higher idle capacity costs and strong pricing pressure in most of our operat-



Pricing pressure and idle capacity costs could not be entirely offset by productivity improvements.

ing segments, as well as the unfavorable U.S. dollar/euro exchange rate, particularly in our Memory Products segment, which could not be entirely offset by productivity measures.

The gross margin development in our operating segments was as follows:

#### --- Automotive, Industrial and Multimarket

In the 2004 financial year, gross margin improved as a result of increased productivity and cost reductions attributable to the conversion from 5-inch to 6-inch and 8-inch wafer manufacturing. Higher sales volumes and increased capacity utilization contributed to improved efficiencies and offset the adverse effect of pricing pressure on gross margin. In the 2005 financial year, gross margin deteriorated as a result of higher idle capacity costs in the first half of the financial year and strong pricing pressure, which could not be fully offset by productivity measures.

#### --- Communication

Gross margin for the 2004 financial year remained stable compared to the 2003 financial year, although it decreased from a high in the second quarter. This decrease resulted principally from a continuing price decline experienced in access products. Gross margin deteriorated in the 2005 financial year mainly due to increased idle capacity costs.

### --- Memory Products

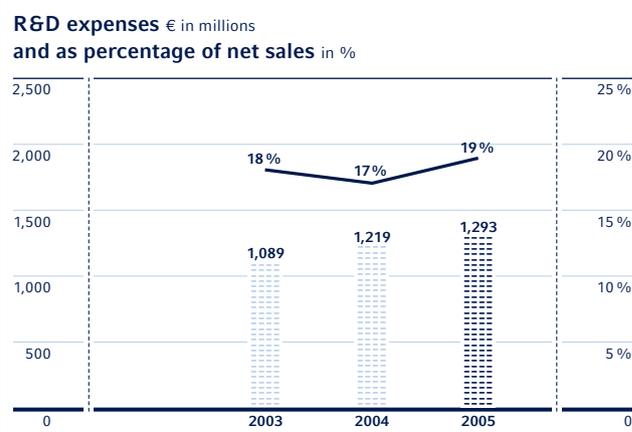
Gross margin improved during the 2004 financial year mainly due to improved productivity and reduced manufacturing costs as a result of the conversion to 140 and 110-nanometer process technologies and 300-millimeter production efficiencies. These more than offset the effects of lower average selling prices and led to a significant increase in gross margin in the second half of the 2004 financial year. The gross margin impact in the 2004 financial year of lower license income was partially offset by reduced depreciation expense attributable to governmental grants. Gross margin decreased in the 2005 financial year, as the improvements of productivity and reduced manufacturing costs resulting from the 110-nanometer process technology conversion and the increasing share of 300-millimeter manufacturing could not compensate for the effect of lower average selling prices and the unfavorable U.S. dollar/euro exchange rate.

### Research and development (R&D) expenses

Research and development expenses consist primarily of salaries and fringe benefits for research and development personnel, materials costs, depreciation and maintenance of equipment used in our research and development efforts, and contracted technology development costs. Materials costs include expenses for development wafers and costs relating to pilot production activities prior to the commencement of commercial production. R&D expenses also include our joint technology development arrangements with partners such as Nanya and IBM.

We continue to focus our investments on the development of leading-edge manufacturing technologies and products with high potential for growth and profitability.

For the years ended September 30	2003	2004	2005
Research and development expenses € in millions	1,089	1,219	1,293
Changes year-on-year		12%	6%
% of net sales	18%	17%	19%
In-process R&D charges € in millions	6	9	0
% of net sales	0%	0%	0%
Government subsidies € in millions	59	74	50
% of net sales	1%	1%	1%



Focus on the development of advanced back-end technologies and products with high growth and profitability potential.

In-process R&D charges relate primarily to the acquisition of SensoNor in the 2003 financial year and ADMtek Inc., Hsinchu, Taiwan ("ADMtek") in the 2004 financial year. In the 2005 financial year we had no acquisitions that resulted in in-process R&D charges. Each charge is unique to the acquisition and depends on a variety of factors such as the stage of technology development and the anticipated future use at the acquisition date.

Some of our R&D projects qualify for subsidies from local and regional governments where we do business. If the criteria to receive a grant are met, the subsidies received reduce R&D expenses over the project term as expenses are incurred.

### --- Automotive, Industrial and Multimarket

During the 2004 financial year, R&D expenses increased in absolute terms and remained constant as a percentage of sales, as a result of increased R&D spending in the fields of microcontrollers and automotive applications. R&D expenses increased slightly both in absolute terms and as a percentage of sales in the 2005 financial year. The increase took place mainly in the automotive and power business.

--- Communication

R&D expenses increased in the 2004 financial year in absolute terms and remained relatively stable as a percentage of sales. This increase was mainly the result of in-process R&D charges in connection with the ADMtek acquisition and additional R&D expenses resulting from our intensified focus on software and solutions activities and third-generation mobile phone semi-conductors. R&D expenses in the 2005 financial year remained relatively stable in absolute terms and increased relative to sales compared to the 2004 financial year. The high level of R&D expenses was maintained in the first half of the 2005 financial year, with a focus on software and solution activities for third-generation mobile phone semiconductors as well as for broadband semiconductor solutions. In the second half of the 2005 financial year, R&D expenses were reduced in absolute terms, reflecting the successful implementation of efficiency programs initiated in the second quarter of the 2005 financial year.

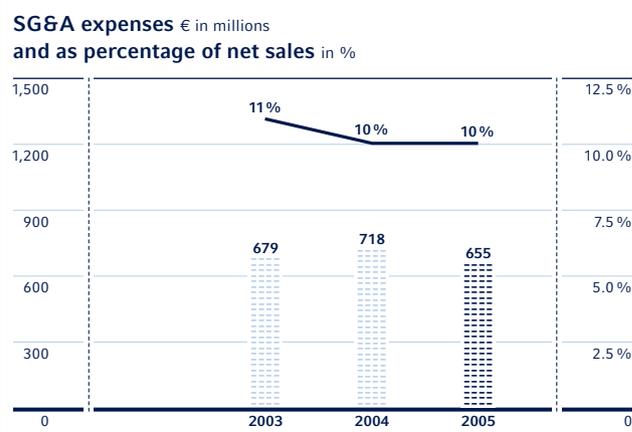
--- Memory Products

In the 2004 financial year, R&D expenses increased in absolute terms, although they remained constant relative to sales, reflecting in particular the development of commodity DRAM and flash technologies, which were not entirely offset by the benefits of the joint development of DRAM technologies with Nanya. In the 2005 financial year, R&D expenses increased in absolute terms due to increased spending on the acceleration of the development of next generation memory technologies and the broadening of the overall memory portfolio.

Selling, General, and Administrative (SG&A) expenses

Selling expenses consist primarily of salaries and fringe benefits for personnel engaged in sales and marketing activities, costs of customer samples, costs related to prototyping activities, other marketing incentives, and related marketing expenses.

General and administrative expenses consist primarily of salaries and benefits for administrative personnel, non-manufacturing-related overhead costs, consultancy, legal and other fees for professional services, and recruitment and training expenses.



Reductions in SG&A expenses as a result of cost-saving measures across the Company.

The slight decline of selling, general, and administrative expenses as a percentage of net sales in the 2004 financial year was mainly due to our sales increasing at a faster rate than our expenditures. During the 2005 financial year, despite the significant increase in sales volume, we were able to reduce selling, general, and administrative expenses in absolute terms as a result of cost reduction measures, particularly in central service providers and information technology (IT).

Selling expenses increased in absolute terms during the 2004 financial year, due to increased sales and higher-volume business as well as expansion in the Asia-Pacific region, partially offset by sales and marketing cost-reduction programs in our Communication and Automotive, Industrial and Multimarket segments. Selling expenses decreased in absolute terms during the 2005 financial year following the decrease in net sales.

The increase in general and administrative expenses during the 2004 financial year was mainly attributable to higher IT expenditures, professional fees, and expenses associated with expanding our presence in the USA and Asia, and was partially offset by savings from our cost-reduction programs. In the 2005 financial year, general and administrative expenses decreased due to general cost-saving measures throughout the Company.

For the years ended September 30	2003	2004	2005
Selling, general, and administrative expenses € in millions	679	718	655
Changes year-on-year		6%	(9%)
% of net sales	11%	10%	10%

### Other items affecting earnings

For the years ended September 30	2003	2004	2005
Restructuring charges € in millions	29	17	78
% of net sales	0 %	0%	1 %
Other operating expense, net € in millions	85	257	92
% of net sales	1 %	4%	1 %
Equity in (losses) earnings of associated companies € in millions	18	(14)	57
% of net sales	0 %	(0 %)	1 %
Other non-operating (expense) income, net € in millions	21	(64)	26
% of net sales	0 %	(1 %)	0 %

### Restructuring charges

In the 2003 financial year we accrued charges for severance payments to eliminate excess overhead. In connection with our decision to close down various development centers in the 2004 financial year, we recorded restructuring charges, mainly for severance payments. In the 2005 financial year, we continued our restructuring and cost-saving efforts aimed at reducing costs, including downsizing our workforce and consolidating certain functions and operations. We agreed upon plans to terminate employees, primarily in connection with the closedown of fiber optics operations in Germany and the United States, as well as measures taken to restructure our chip manufacturing in the front-end area within the manufacturing cluster Perlach, Regensburg, and Villach. Production activities at Munich-Perlach will be transferred principally to Regensburg and, to a lesser extent, to Villach.

### Other operating expense, net

Other operating expense, net, in the 2004 financial year related principally to charges from our settlement of an antitrust investigation by the U.S. Department of Justice, related settlements with customers, and a similar ongoing investigation in Europe, as well as a goodwill impairment charge of €71 million related to our 2001 acquisition of Catamaran. In the 2005 financial year, other operating expense included a net charge of €96 million resulting primarily from the reorganization of certain communication businesses and goodwill and other intangible assets impairment charges.

### Equity in (losses) earnings of associated companies

Our principal associated companies are ALTIS, Inotera (since the 2003 financial year) and ProMOS (through part of the 2003 financial year). Both ProMOS and Inotera are DRAM manufacturers and our equity in their earnings has been sensitive to fluctuations in the price of DRAM and is reflected in the results of the Memory Products segment.

In the 2003 financial year, the recovery in DRAM prices resulted in improved earnings at ProMOS prior to our withdrawal from the venture. Start-up losses at Inotera during the ramp-up phase of production contributed to the losses incurred in the 2004 financial year. In the 2005 financial year, Inotera contributed the majority of our equity in earnings from associated companies, reflecting the start of volume production by that joint venture.

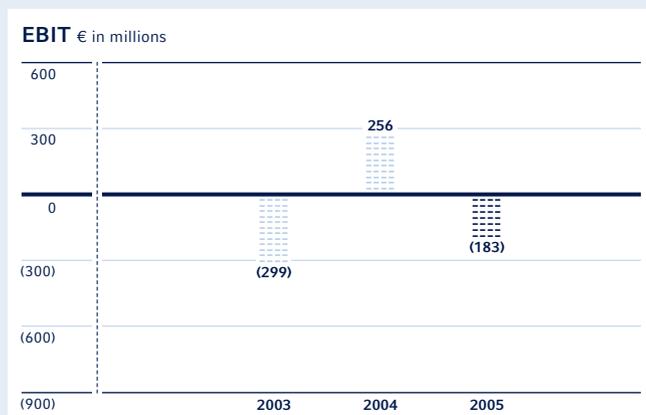
### Other non-operating (expense) income, net

Other non-operating income and expense can consist of various items from period to period not directly related to our principal operations, including gains and losses on sales of marketable securities. Other non-operating expense, net, in the 2004 financial year mainly consisted of €65 million of investment-related impairment charges. In the 2005 financial year, other non-operating income, net, included €40 million related to net gains from foreign currency derivatives and foreign currency transactions and a gain of €13 million realized on the sale of our venture capital activities, partially offset by investment-related impairment charges of €29 million.

### Earnings before interest and taxes (EBIT)

We define EBIT as earnings (loss) before interest and taxes. Our management uses EBIT as a measure to establish budgets and operational goals, to manage our business and to evaluate its performance. We report EBIT information because we believe that it provides investors with meaningful information about our operating performance and especially about the performance of our separate operating segments. EBIT is determined from the consolidated statements of operations as follows:

For the years ended Sep. 30 € in millions	2003	2004	2005
Net income (loss)	(435)	61	(312)
Add: Income tax expense	84	154	120
Interest expense, net	52	41	9
<b>EBIT</b>	<b>(299)</b>	<b>256</b>	<b>(183)</b>



Pricing pressure, weaker U.S. dollar/euro exchange rate and other charges had a negative impact on EBIT.

The EBIT results reflect the combined effects of the following EBIT movements of our reporting segments:

#### --- Automotive, Industrial and Multimarket

The EBIT improvement in the 2004 financial year was mainly due to higher sales volumes and improved manufacturing efficiency, partially offset by continued pricing pressure. The EBIT decline in the 2005 financial year resulted primarily from the deterioration of the gross margin. As part of that, EBIT was negatively impacted by costs related to product transfers in connection with the planned phase-out of production at Munich-Perlach and costs incurred in connection with our new production site in Kulim, Malaysia.

#### --- Communication

The EBIT loss decreased in the 2004 financial year, primarily due to lower operating costs, which were partially offset by losses associated with the acquisition of ADMtek. EBIT for the 2004 financial year included goodwill impairments of €71 million related to our Catamaran acquisition. The EBIT decrease in the 2005 financial year resulted mainly from charges in connection with the reorganization of certain communication businesses and impairment charges aggregating €96 million, as well as a decline in gross margin.

#### --- Memory Products

The EBIT improvement in the 2004 financial year was primarily due to increased sales volumes and productivity improvements, which offset the impact of the weak U.S. dollar/euro exchange rate, lower license income and antitrust related charges. The EBIT decline in the 2005 financial year resulted primarily from

The EBIT amounts of our separate reporting segments were as follows<sup>1</sup>:

For the years ended Sep. 30 € in millions	2003	2004	2005
Automotive, Industrial and Multimarket	148	252	134
Communication	(213)	(44)	(295)
Memory Products	31	169	122
Other Operating Segments	(50)	(75)	(4)
Corporate and Reconciliation	(215)	(46)	(140)
<b>Total</b>	<b>(299)</b>	<b>256</b>	<b>(183)</b>

<sup>1</sup> Amounts in prior periods have been conformed to the current year presentation.

a decline of average selling prices for DRAM products and the weak U.S. dollar/euro exchange rate, as well as the increase in R&D expenses resulting from the acceleration of our technology development and the broadening of our product portfolio, which could not be entirely offset by productivity improvements and increasing license revenue.

#### --- Other Operating Segments

The EBIT losses in the 2003 and 2004 financial years mainly reflected investment-related impairment charges. EBIT in the 2005 financial year was positively impacted by a gain of €13 million realized on the sale of our venture capital activities.

#### --- Corporate and Reconciliation

The EBIT loss decreased in the 2004 financial year, principally reflecting reduced idle-capacity costs resulting from improved utilization. The EBIT deterioration in the 2005 financial year resulted primarily from restructuring charges of €78 million in connection with the planned phase-out of production at our Munich-Perlach facility and the restructuring of our fiber optics business.

#### Interest expense, net

We derive interest income primarily from cash and cash equivalents and marketable securities. Interest expense is primarily attributable to bank loans and convertible notes, and excludes interest capitalized on manufacturing facilities under construction.

For the years ended September 30	2003	2004	2005
Interest expense, net € in millions	(52)	(41)	(9)
% of net sales	(1%)	(1%)	0%

Interest expense in the 2003, 2004, and 2005 financial years relates principally to the convertible bonds that we issued in February 2002 and in June 2003. In addition, interest expense in the 2004 financial year included €21 million, paid upon redemption of the other investors' ownership interests in the Infineon Technologies SC300 GmbH & Co. OHG ("SC300") venture in Dresden. These effects were partially reduced in the 2004 and 2005 financial years as a result of the redemption of a portion of our convertible bonds in 2004 and increased interest capitalization related to facilities under construction, as well as interest income from financial derivatives.

### Income taxes

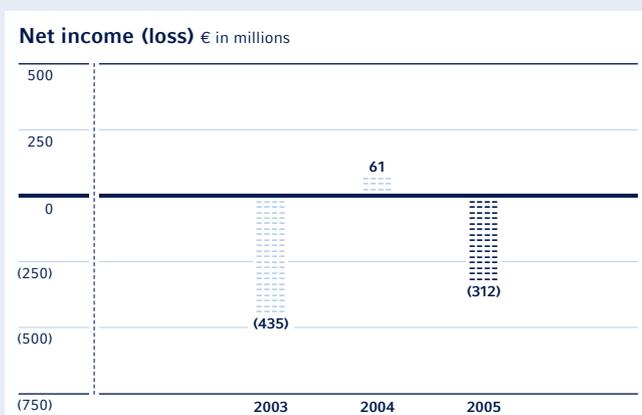
For the years ended September 30	2003	2004	2005
Income tax expense € in millions	(84)	(154)	(120)
% of net sales	(1%)	(2%)	(2%)
Effective tax rate	(24%)	72%	(63%)

Pursuant to U.S. GAAP, deferred tax assets in tax jurisdictions that have a three-year cumulative loss are subject to a valuation allowance excluding the impact of forecasted future taxable income. In the 2003 financial year we recorded an increase to the valuation allowance of €182 million, which limited the net tax benefit recognized, because we had incurred a cumulative loss in certain tax jurisdictions over the three-year period ended

September 30, 2003; however, we continued to record tax expense in profitable tax jurisdictions. In the 2004 financial year, our effective tax rate increased because we recorded additional valuation allowances of €54 million related to tax jurisdictions that continue to have a three-year cumulative loss, and also had more non-deductible expenditures. In the 2005 financial year, as in the 2004 financial year, we continued to have a three-year cumulative loss in certain tax jurisdictions and we recorded an increase to the valuation allowance of €192 million. We assess our deferred tax asset position on a regular basis. Our ability to realize benefits from our deferred tax assets is dependent on our ability to generate future taxable income sufficient to utilize tax loss carry-forwards or tax credits before expiration. We expect to continue to recognize no tax benefits in these jurisdictions until we have ceased to be in a cumulative loss position for the preceding three-year period.

### Net income (loss)

Net loss decreased significantly in the 2003 financial year principally as a result of sales volume growth and manufacturing efficiencies and cost reduction efforts. This trend continued in the 2004 financial year, resulting in the achievement of profitability, although the impact was reduced through the increased charges for impairments, antitrust-related matters and tax expense. In the 2005 financial year, the net loss incurred resulted primarily from the combination of lower revenues and gross margin, long-term asset impairments, restructuring measures and tax expense.



Lower net sales and gross margin, as well as restructuring charges contributed to the net loss incurred.



**FINANCIAL CONDITION**

As of September 30, 2005 € in millions	2004	2005	% Change year-on-year
Current assets	5,292	4,574	(14 %)
Non-current assets	5,572	5,710	3 %
<b>Total assets</b>	<b>10,864</b>	<b>10,284</b>	<b>(5 %)</b>
Current liabilities	2,870	2,382	(17 %)
Non-current liabilities	2,016	2,273	13 %
<b>Total liabilities</b>	<b>4,886</b>	<b>4,655</b>	<b>(5 %)</b>
<b>Shareholders' equity</b>	<b>5,978</b>	<b>5,629</b>	<b>(6 %)</b>

As of September 30, 2005, our total assets decreased slightly in comparison to the prior year. Total current assets decreased at the end of the 2005 financial year primarily due to the repayment of a €450 million loan entered into in connection with the build-out of our plant in Dresden.

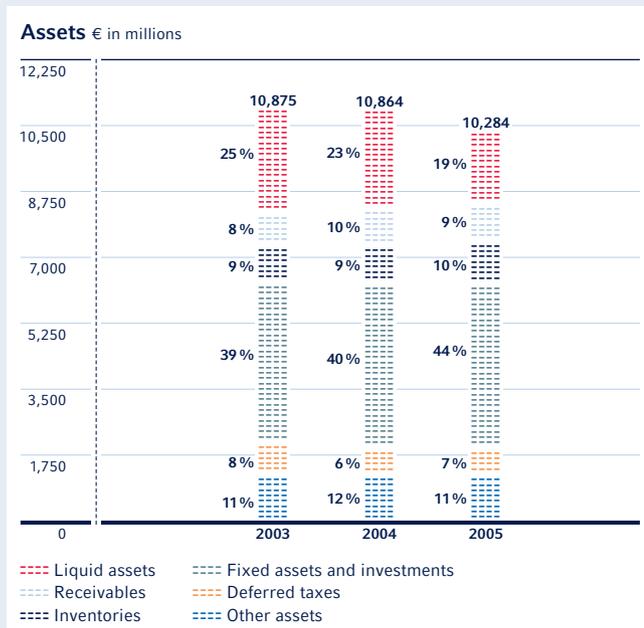
Non-current assets increased slightly at the end of the 2005 financial year as depreciation, amortization and impairment charges mostly offset capital expenditures and investments in associated companies during the year.

Total liabilities decreased slightly as of the end of the 2005 financial year, mainly due to the net effect of the repayment of a €450 million loan entered into in connection with the build-out

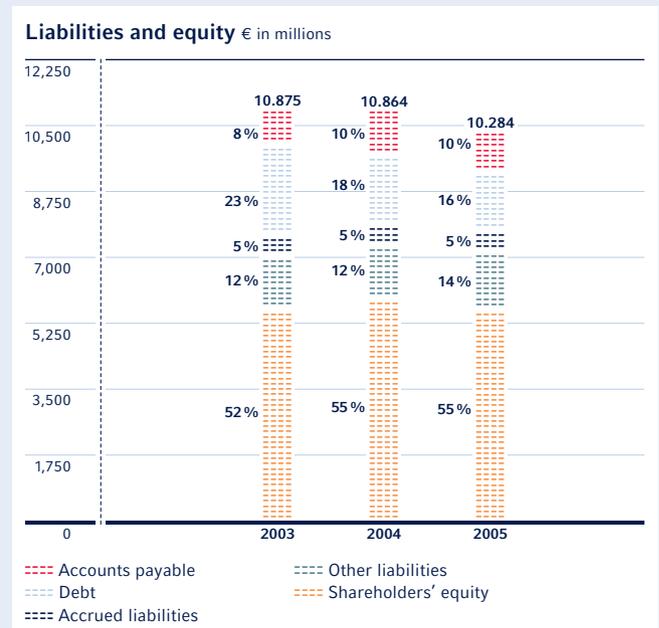
of our plant in Dresden which was not entirely offset by long-term debt borrowings of €175 million. The decrease in current liabilities resulted primarily from the repayment of the €450 million loan. Non-current liabilities increased mainly due to long-term debt borrowings of €175 million, used primarily for the financing of R&D projects and manufacturing facilities in Portugal and Austria.

In the 2005 financial year our shareholders' equity decreased principally due to the net loss during the year. At September 30, 2005, shareholders' equity as a percentage of total assets was 55 percent, unchanged from September 30, 2004.

The equity return amounted to negative 5 percent and the return on assets amounted to negative 3 percent in the 2005 financial year, compared to positive 1 percent for both financial ratios in the 2004 financial year. The equity-to-fixed-assets ratio decreased to 150 percent in the 2005 financial year from 167 percent in the prior year as a result of the net loss and capital expenditures which exceeded depreciation expense during the year. The decrease of the debt-to-equity ratio to 30 percent, compared to 33 percent in the 2004 financial year, was mainly attributable to the repayment of the €450 million loan entered into in connection with the build-out of our plant in Dresden during the 2005 financial year.



Liquid assets decreased due to the repayment of debt.



Debt decreased due to the redemption of a loan.

## LIQUIDITY

### Cash flow

For the years ended September 30 € in millions	2003	2004	2005
Net cash provided by operating activities – continuing operations	731	1,857	1,039
Net cash used in investing activities	(1,522)	(1,809)	(238)
Net cash provided by (used in) financing activities	566	(402)	(266)
Net cash used in operating activities – discontinued operation	(1)	–	–
Cash and cash equivalents at end of year	969	608	1,148

Our consolidated statement of cash flows shows the sources and uses of cash during the reported periods. It is of key importance for the evaluation of our financial position.

Cash flows from investing and financing activities are both indirectly determined based on payments and receipts. Cash flows from operating activities are determined indirectly from net income (loss). The changes in balance sheet items have been adjusted for the effects of foreign currency exchange fluctuations and for changes in the scope of consolidation. Therefore, they do not conform to the corresponding changes in the respective balance sheet line items.

Cash provided by operating activities in the 2005 financial year resulted mainly from the net loss of €312 million, which is net of non-cash charges for depreciation of €1,316 million, impairment charges of €134 million, and deferred income taxes of €88 million. Cash provided by operating activities was positively impacted by a decrease of trade accounts receivable of €119 million. These effects were partly offset by a decrease in accrued liabilities and trade accounts payable of €166 million.

Cash used in investing activities in the 2005 financial year mainly reflects capital expenditures of €1,368 million, principally to equip our plants in Dresden and Richmond, investments of €135 million in associated companies, such as our Inotera joint venture, net sales of marketable securities of €1,082 million, and proceeds from the sale of businesses of €101 million.

Cash used in financing activities in the 2005 financial year principally relates to the repayment of a €450 million loan entered into in connection with the build-out of our plant in Dresden.



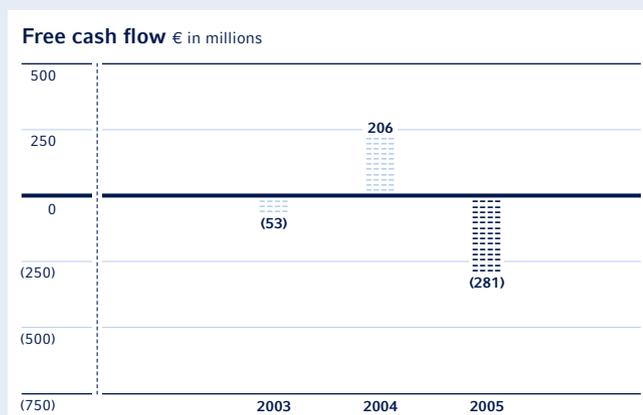
Capital expenditures in property, plant and equipment and equity investments contribute to improved productivity and the extension of capacity.  
<sup>1</sup> Without marketable securities.

### Free cash flow

We define free cash flow as cash from operating and investing activities excluding purchases or sales of marketable securities. Since we hold a substantial portion of our available monetary resources in the form of readily available marketable securities, and operate in a capital-intensive industry, we report free cash flow to provide investors with a measure that can be used to evaluate changes in liquidity after taking capital expenditures into account. It is not intended to represent the residual cash flow available for discretionary expenditures, since debt service

requirements or other non-discretionary expenditures are not deducted. The free cash flow is determined as follows from the consolidated statements of cash flows:

For the years ended Sep. 30 € in millions	2003	2004	2005
Net cash provided by operating activities – total	730	1,857	<b>1,039</b>
Net cash used in investing activities	(1,522)	(1,809)	<b>(238)</b>
Purchases (sale) of marketable securities, net	739	158	<b>(1,082)</b>
<b>Free cash flow</b>	<b>(53)</b>	<b>206</b>	<b>(281)</b>



Net cash provided by operating activities could not offset the net cash used in investing activities excluding proceeds from sales of marketable securities.

### Net cash position

The following table presents our gross and net cash positions and the maturity of debt. It is not intended to be a forecast of cash available in future periods.

As of September 30, 2005 € in millions, payments due by period:	Total	Less than 1 year	1–2 years	2–3 years	3–4 years	4–5 years	After 5 years
Cash and cash equivalents	<b>1,148</b>	1,148	–	–	–	–	–
Marketable securities	<b>858</b>	858	–	–	–	–	–
Gross cash position	<b>2,006</b>	2,006	–	–	–	–	–
Less:							
Long-term debt	<b>1,566</b>	–	650	51	64	733	68
Short-term debt and current maturities	<b>99</b>	99	–	–	–	–	–
<b>Total financial debt</b>	<b>1,665</b>	99	650	51	64	733	68
<b>Net cash position</b>	<b>341</b>	1,907	(650)	(51)	(64)	(733)	(68)

Our gross cash position – representing cash and cash equivalents, plus marketable securities – decreased to €2,006 million at September 30, 2005, compared with €2,546 million at the prior year end. The decrease was principally due to the repayment of a €450 million loan entered into in connection with the build-out of our plant in Dresden.

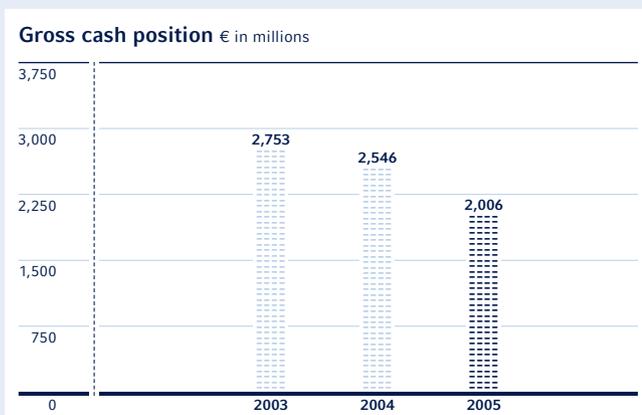
Long-term debt principally consists of convertible notes that were issued in order to strengthen our liquidity position and allow us more financial flexibility in conducting our business operations. The total outstanding convertible notes as of September 30, 2005, amounted to €1,340 million.

On June 5, 2003, we issued €700 million in subordinated convertible notes due 2010 at par in an underwritten offering to institutional investors in Europe. The notes are convertible, at the option of the holders of the notes, into a maximum of 68.4 million ordinary shares of our Company, at a conversion price of €10.23 per share through maturity.

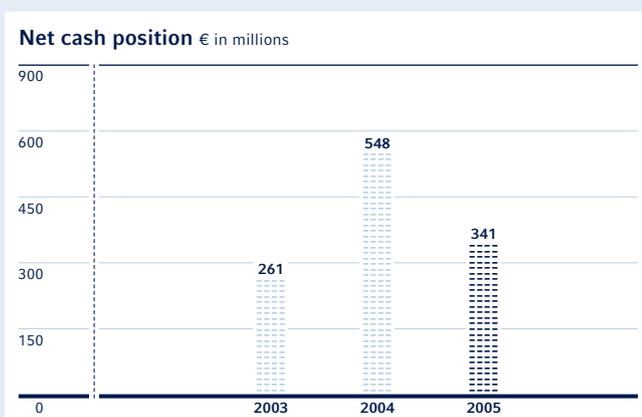
On February 6, 2002, we issued €1,000 million in subordinated convertible notes due 2007 at par in an underwritten offering to institutional investors in Europe. The notes are convertible, at the option of the holders of the notes, into a maximum of 28.2 million of our Company's ordinary shares at a conversion price of €35.43 per share through maturity. During the 2004 financial year we redeemed €360 million of our convertible notes due 2007. As of September 30, 2005, the outstanding amount was €640 million.

Our net cash position – meaning cash and cash equivalents, plus marketable securities, less total financial debt – decreased by €207 million to €341 million at September 30, 2005, compared with €548 million at September 30, 2004, principally as a result of negative free cash flow of €281 million.

To secure our cash position and to keep flexibility with regards to liquidity, we have implemented a policy with risk limits for the amounts deposited with respect to the counterparty, credit rating, sector, duration, credit support, and type of instrument.



Gross cash position decreased due to the repayment of debt.



Net cash position decreased as a result of the net loss.

### Capital requirements

We require capital in our 2006 financial year to:

- finance our operations;
- make scheduled debt payments;
- settle contingencies if they occur; and
- make planned capital expenditures.

We can meet these requirements through:

- cash flow generated from operations;
- cash on hand and securities we can sell; and
- available credit facilities.

As of September 30, 2005, we require funds for the 2006 financial year aggregating €1,618 million, consisting of €99 million for short-term debt payments and €1,519 million for commitments. In addition, we may need up to €166 million for currently known contingencies. We also plan to invest up to an additional €700 million in capital expenditures that have not been otherwise committed. The aggregate capital required for such commitments, contingencies, and planned capital expenditures during the 2006 financial year is €2,484 million as of September 30, 2005. We have a gross cash position of €2,006 million as of September 30, 2005, and also the ability to draw funds from available credit facilities of €1,149 million.

As of September 30, 2005, we had debt of €99 million scheduled to become due within one year.

## Commitments and contingencies

As of September 30, 2005 <sup>1,2</sup> € in millions, payments due by period:							
	Total	Less than 1 year	1–2 years	2–3 years	3–4 years	4–5 years	After 5 years
<b>Contractual commitments:</b>							
Operating lease payments	850	94	71	61	56	54	514
Unconditional purchase commitments	1,505	1,379	45	24	9	9	39
Other long-term commitments	138	46	46	46	–	–	–
<b>Total commitments</b>	<b>2,493</b>	<b>1,519</b>	<b>162</b>	<b>131</b>	<b>65</b>	<b>63</b>	<b>553</b>
<b>Other contingencies:</b>							
Guarantees	462	99	204	23	5	–	131
Contingent government grants <sup>3</sup>	516	67	101	128	42	55	123
<b>Total contingencies</b>	<b>978</b>	<b>166</b>	<b>305</b>	<b>151</b>	<b>47</b>	<b>55</b>	<b>254</b>

The above table should be read together with Note 31 to our consolidated financial statements for the year ended September 30, 2005.

1 Certain payments of obligations or expiration of commitments that are based on the achievement of milestones or other events that are not date-certain are included for purposes of this table, based on our estimate of the reasonably likely timing of payments or expirations in each particular case. Actual outcomes could differ from those estimates.

2 Product purchase commitments associated with capacity reservation agreements are not included in this table, since the purchase prices are based, in part, on future market prices, and are accordingly not quantifiable at September 30, 2005. Purchases under these agreements aggregated approximately €950 million for the year ended September 30, 2005.

3 Contingent government grants refer to amounts previously received, related to the construction and financing of certain production facilities, which are not guaranteed otherwise and could be refundable if the total project requirements are not met.

## Capital expenditures

For the years ended Sep. 30 € in millions	2003	2004	2005
Memory products	576	716	921
Logic products	296	447	447
<b>Total</b>	<b>872</b>	<b>1,163</b>	<b>1,368</b>

Depending on our business situation we expect to invest between €1.2 billion and €1.4 billion in capital expenditures in the 2006 financial year, largely for our manufacturing facilities in Richmond, Virginia, and Kulim, Malaysia. We are also constantly improving productivity and upgrading technology at existing facilities, especially in Dresden, Germany. As of September 30,

2005, approximately €650 million of this amount has been committed and included in unconditional purchase commitments. Due to the lead times between ordering and delivery of equipment, a substantial amount of capital expenditures typically is committed well in advance. Approximately 50 percent of these expected capital expenditures will be made in the Memory Products segment's front-end and back-end facilities.

## Credit facilities

We have established both short and long-term credit facilities with a number of different financial institutions in order to meet our anticipated funding requirements. These facilities, which aggregate €1,491 million, of which €1,149 million remained available at September 30, 2005, comprise the following:

Credit facilities € in millions					
Term	Nature of financial institution commitment	Purpose/intended use	As of September 30, 2005		
			Aggregate facility	Drawn	Available
short-term	firm commitment	working capital, guarantees	120	51	69
short-term	no firm commitment	working capital, cash management	305	–	305
long-term	firm commitment	working capital	731	–	731
long-term <sup>1</sup>	firm commitment	project finance	335	291	44
<b>Total</b>			<b>1,491</b>	<b>342</b>	<b>1,149</b>

1 Including current maturities.

In September 2004 we executed a \$400/€400 million syndicated credit facility with a five-year term. The facility consists of two tranches: Tranche A is a \$400 million term loan intended to finance the expansion of our Richmond, Virginia, manufacturing facility. Tranche B is a €400 million multicurrency revolving facility to be used for general corporate purposes. The maximum outstanding amount of Tranche A will decrease on the basis of a repayment schedule that foresees equal installments starting from September 30, 2006. The facility has customary financial covenants, and drawings bear interest at market-related rates that are linked to financial performance. The lenders of this credit facility have been granted a negative pledge relating to our future financial indebtedness with certain permitted encumbrances. At September 30, 2005, no amounts were outstanding under this facility.

A €124 million non-recourse project financing facility for the expansion of the Porto, Portugal, manufacturing facility was executed in May 2005. As of September 30, 2005, €80 million has been drawn under this facility.

At September 30, 2005, we were in compliance with our debt covenants under the relevant facilities.

We plan to fund our working capital and capital requirements from cash provided by operations, available funds, bank loans, government subsidies and, if needed, the issuance of additional debt or equity securities. We have also applied for governmental subsidies in connection with certain capital expenditure projects, but can provide no assurance that such subsidies will be granted on a timely basis or at all. We can provide no assurance that we will be able to obtain additional financing for our research and development, working capital, or investment requirements or that any such financing, if available, will be on terms favorable to us.

Taking into consideration the financial resources available to us, including our internally generated funds and currently available banking facilities, we believe that we will be in a position to fund our capital requirements in the 2006 financial year.

### Pension plan funding

Our Company's projected benefit obligation, which considers future compensation increases, amounted to €477 million at September 30, 2005, compared to €349 million at September 30, 2004. The fair value of plan assets as of September 30, 2005, was €243 million, compared to €204 million as of September 30, 2004.

We have estimated the return on plan assets for the next financial year to be 6.5 percent or €14 million for domestic plans and 6.7 percent or €2 million for foreign plans. The actual return on plan assets between the last measurement dates amounted to 10.9 percent or €19 million for domestic plans and 6.7 percent or €2 million for foreign plans, compared to the expected return on plan assets for that period of 7.3 percent for domestic plans and 6.9 percent for foreign plans.

At September 30, 2004 and 2005, the combined funding status of our pension plans reflected an underfunding of €145 million and €234 million, respectively. The Company expects that contributions to its pension plans during the year ending September 30, 2006, would significantly exceed the level of contributions made during the year ended September 30, 2005.

Our investment approach with respect to the pension plans involves employing a sufficient level of flexibility to capture investment opportunities as they occur, while maintaining reasonable parameters to ensure that prudence and care are exercised in the execution of the investment program. The pension plans' assets are invested with several investment managers. The plans employ a mix of active and passive investment management programs. Considering the duration of the underlying liabilities, a portfolio of investments of plan assets in equity securities, debt securities, and other assets is targeted to maximize the long-term return on plan assets for a given level of risk. Investment risk is monitored on an ongoing basis through periodic portfolio reviews, meetings with investment managers and liability measurements. Investment policies and strategies are periodically reviewed to ensure the objectives of the plans are met considering any changes in benefit plan design, market conditions, or other material items.

Our asset allocation targets for pension plan assets are based on our assessment of business and financial conditions, demographic and actuarial data, funding characteristics, related risk factors, market sensitivity analyses and other relevant factors. The overall allocation is expected to help protect the plans' level of funding while generating sufficiently stable real returns (i.e., net of inflation) to meet current and future benefit payment needs. Due to active portfolio management, the asset allocation may differ from the target allocation up to certain limits. As a matter of policy, our pension plans do not invest in our Company shares.

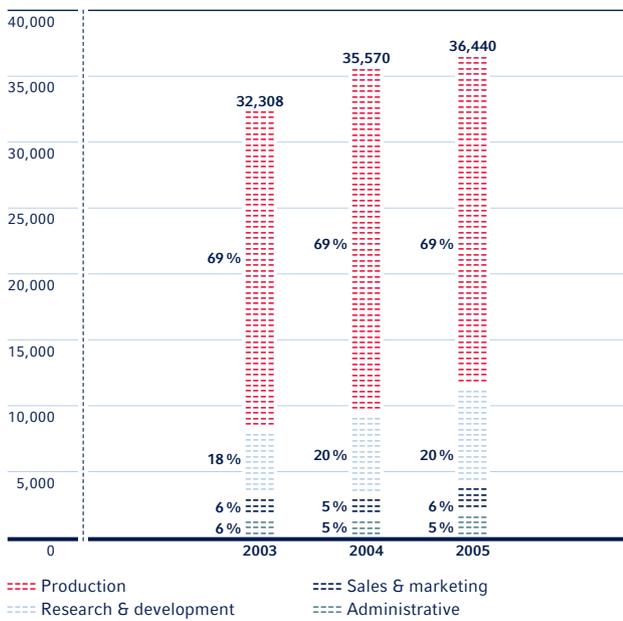
**EMPLOYEES AND CAMPEON**

**Employees**

The following table indicates the composition of our workforce by function and region at the end of the financial years indicated.

As of September 30	2003	2004	2005
<b>Function:</b>			
Production	22,405	24,540	<b>25,114</b>
Research & Development	5,935	7,160	<b>7,401</b>
Sales & Marketing	2,048	1,948	<b>2,016</b>
Administrative	1,920	1,922	<b>1,909</b>
<b>Total</b>	<b>32,308</b>	<b>35,570</b>	<b>36,440</b>
<b>Region:</b>			
Germany	16,166	16,387	<b>16,119</b>
Europe	5,034	5,631	<b>5,482</b>
North America	2,757	2,982	<b>3,193</b>
Asia-Pacific	8,116	10,340	<b>11,451</b>
Japan	118	133	<b>158</b>
Other	117	97	<b>37</b>
<b>Total</b>	<b>32,308</b>	<b>35,570</b>	<b>36,440</b>

**Employees by function<sup>1</sup>**



Increase of workforce for the benefit of research and development.  
1 Columns may not add up due to rounding.

In the 2004 financial year, our headcount increased principally due to the expansion of manufacturing capacities in Germany, Malaysia and China. In the 2005 financial year, this trend continued in Malaysia and China.

**Campeon**

We entered into a long-term operating lease agreement with MoTo Objekt Campeon GmbH & Co. KG ("MoTo") to lease an office complex constructed by MoTo south of Munich, Germany. The office complex, called Campeon, will enable us to centralize most of our Munich-area employees, who are currently situated in various locations throughout Munich, in one central physical working environment. MoTo was responsible for the construction, which was completed in the second half of 2005. We have no obligations with respect to financing MoTo, and have provided no guarantees related to the construction. We occupied Campeon under an operating lease arrangement in October 2005, and have begun the gradual move of our employees to this new location.

**RISKS AND OPPORTUNITIES**

**Introduction**

Like no other business, the semiconductor industry is characterized by periods of growth which are historically followed by periods of market contraction. Such periods of market contraction are characterized by surplus capacity, order cancellations as well as price erosion and sales volume reductions. The risks associated with the cyclical nature of this business are compounded by the need for large scale capital investments in order to achieve and sustain market leadership as well as the sector's rapid pace of technological change. These risks are, however, often accompanied by substantially greater opportunities.

**Infineon risk management system**

Given the volatility of the business cycle in the semiconductor industry it is very important that the risk and opportunity management policies are geared towards the goal of resilient profitable growth. The ability to quickly react to changing market developments is therefore crucial. To this end we have established a risk and opportunity management system which allows us to exploit the many significant opportunities manifesting themselves in our markets and to anticipate and identify risks associating or arising from them. An enterprise-wide system of risk and opportunity reporting is a central element of our risk and opportunity management system. The scope and depth of reporting helps to enable corporate management to take quick and effective actions whenever situations so require. Within every organizational unit of the Company, risk officers or risk reporters have been designated to implement and execute the risk and opportunity reporting process. According to the guide-

lines for this process, risks and opportunities are identified within the framework of a risk and opportunity categorization model, accompanied by an evaluation of each risk and opportunity based on its respective probability and effect upon EBIT. The risk management system is extensively documented in our intranet and thus accessible by our employees worldwide.

The reporting system is based upon individual observations of risk and opportunity and is composed of a range of monitoring and management processes embedded in our core processes. It commences at the level of strategic planning and continues through the manufacturing and sales operations, including the processing of receivables. As an extension of the forecasting processes conducted by the business groups, the sales organization, the manufacturing clusters and the central functions, the risk and opportunity system is used to identify and evaluate possible deviations from expected developments. Beyond the identification and evaluation of major developments that may impact the business, the system is also used to prioritize and implement activities to enhance opportunities and mitigate or reduce our risk.

Risk and opportunity reports are issued on a regular basis by all of our business units. These reports form the core of the risk management system. The reports are examined and evaluated by the Management Board and business group management as part of their reviewing process.

Alongside the enterprise-wide reporting system, we have established a quantitative risk analysis process for our manufacturing and research and development activities in order to provide greater transparency of risks and prioritize measures designed to enhance the probabilities of success of these activities. Furthermore, this quantitative risk analysis methodology is being applied to financial decision-making processes, in particular to investment decisions and forecasting processes. The goal of employing this methodology is to ensure that appropriate risk mitigation and opportunity enhancement strategies are chosen and implemented.

The systematic development of existing systems of risk analysis and the creation of new early warning systems substantially contribute to the enhancement and sustainability of a risk and opportunity culture within the Company. This is supported by regular Risk & Opportunity Forum meetings involving the risk officers of the Company. These meetings provide a communication platform for exchanging ideas and information on risk analysis and risk management; they furthermore provide a basis for the creation of awareness of this important subject matter throughout the Company.

In the course of an annual Risk Management System Analysis ("RMSA") our Business Groups and Central Functions are called upon to review the effectiveness and efficiency of the key elements of the Infineon Risk and Opportunity Management System. This is executed via self-assessment using a questionnaire which is crafted to facilitate improvements and support the audit process, both by our internal and external auditors.

Our risk and opportunity reporting system has been evaluated by the external auditors as part of the annual audit process. The external auditors have confirmed that the Management Board has fulfilled its obligation according to paragraph 91 subsection 2 of the German Law on Stock Companies ("Aktiengesetz"), which calls for the creation of a reporting system which enables management to receive early warning of developments which may endanger the existence of the Company as a whole.

### Global business risks

Substantial changes in regional business environments around the globe may have adverse affects on our business and results of operations.

Our global business strategy implies that we maintain research and development locations as well as manufacturing sites in many countries around the world. This may be the result of strategic decisions to enhance our cost competitiveness, overcome market entry hurdles or enhance opportunities related to technology development. More than half of our sales volume is generated outside of Europe. With the expected growth rates of Asian countries in the near future we expect our investments to increase in this region. Therefore risks could develop based upon:

- negative economic developments in foreign economies and instability of foreign governments, including the threat of war or civil unrest;
- changes in laws and policies affecting trade and investment; and
- varying practices of the regulatory, tax, judicial and administrative bodies in the jurisdictions where we operate.

Substantial changes in any of these conditions could have an adverse affect on our business and results of operations. It cannot be excluded that regional crises like the SARS epidemic in 2003 will not have any negative effects on our business or profitability. However, broad diversification within our product portfolio and the spread of development and manufacturing locations around the world provide an effective approach to mitigate the overall risk of such regional crises as the dependencies are generally reduced.

### Risks related to our operations

From our Memory Product segment the volatility of DRAM-memory prices remains the most important risk but also the most prominent opportunity both for this segment as well as for the Company as a whole. In the past financial year the market price of our main product, the 256 Mbit DDR SDRAM varied between U.S. \$4.82 and U.S. \$2.25 (source: DRAM Exchange, 256 M DDR 400 average). Through our entry into the market for flash memory products we are expanding our product portfolio which carries both opportunities but also substantial risks. These risks are compounded by the strong position of our competitors in particular in terms of market share and technological capabilities. In relation to the previous financial year we also see substantial manufacturing risks as we are currently ramping the newest 90-nanometer manufacturing technology at a number of our production sites. Within the Logic segments of our business, Automotive, Industrial and Multimarket as well as Communication we see comparatively less volatility than in the Memory Products segment but nonetheless substantial volume risks. The quick pace of technological change coupled with the possibility of delays in the introduction of new products in the market can have a significant effect on our production volumes which may in turn influence the relationships with our major customers. Price pressure for individual products within the competitive market environment may further influence our margins in these business segments. As a substantial volume of our products may be purchased by a select number of customers, our operational results may also be dependant upon their success in the marketplace. Developments in the market which are not within our sphere of influence, such as the sale of the mobile phone unit of Siemens AG to BenQ, may also have negative effects on our potential business volume.

In order to address the risks relating to the quality of our products we have established continuous quality improvement initiatives within the product development, manufacturing and logistic processes. Our quality management system (which includes the deliveries of our suppliers) has been certified on a worldwide basis according to ISO 9001/TS 16949 for a number of years.

We have procured insurance coverages to limit the impact of losses, incidents or certain other events posing possible perils and threats to our assets, finances or earnings.

In the area of intellectual property, the Company has signed a number of cross-license agreements with other companies. The Company is working intensively to increase the number and scope of such cross-license agreements with other companies in order to reduce the risk of claims for patent infringement.

Tax, fair trade and stock exchange regulations can all supply a basis for additional risks. To mitigate the cause and effect of these risks we rely upon the counsel of professionals, including both the advice of our own employees as well as the advice of independent service providers.

### Market risks

#### Exchange rate risks

Our involvement and participation in various regional markets around the world creates cash flows in a number of different currencies – primarily in U.S. dollars. Since we are exposed to fluctuating currencies and substantial volatility relating to exchange rates, the management of these risks becomes an important issue.

A major portion of our sales volumes as well as the costs relating to the design, production and manufacturing of products are based in U.S. dollars, not in euros. Exchange rate fluctuations may have substantial effects on our sales, our costs and our overall results of operations.

Our policy with respect to limiting short-term foreign currency exposure generally is to economically hedge at least 75 percent of our estimated net exposure for a minimum period of two months in advance and, depending on the nature of the underlying transactions, a significant portion for the periods thereafter. Parts of our foreign currency exposure cannot be mitigated due to differences between actual and forecasted amounts. We calculate this net exposure on a cash flow basis considering actual orders received or made and all other planned revenues and expenses.

#### Interest rate risk management

We are exposed to interest rate risk through our debt instruments, fixed term deposits and loans. During the 2002 and 2003 financial years, we issued two convertible bonds. Due to the high volatility of our core business and to maintain high operational flexibility, our current assets are kept at a high level. These assets are mainly deposited in instruments with short term interest rates. To reduce the risk caused by changes in the market interest rates, the duration of the interest rates of our debts and current assets are aligned by the use of interest rate derivatives.

### Commodity price risk

We are exposed to commodity price risks with respect to raw materials used in the manufacture of our products. We seek to minimize the risks through our sourcing policies and operating procedures. We do not utilize derivative financial instruments to manage any remaining exposure to fluctuations in commodity prices.

### Financing risks

Semiconductor companies that operate their own manufacturing facilities require significant amounts of capital to build, expand, modernize and maintain them. Semiconductor companies also require significant amounts of capital to fund research and development. These capital requirements should generally be financed by incoming cash flow, the use of available credit lines, available public funding for projects and – depending upon market conditions – capital market offerings. Although we have applied for financial support from public authorities on a number of projects, we may not be able to guarantee that we will be able to raise the amount of capital required for our business from these sources in a timely and successful fashion. We intend to continue the policy of cooperation with other semiconductor companies to share the costs of research and development as well as to create joint production facilities.

### Legal risks

As this applies to many companies within the semiconductor industry, Infineon has been exposed to patent claims, claims relating to alleged defective or faulty products, claims relating to the alleged transgression of environmental rules or regulations and other general liability claims. Regardless of the outcome of these claims, the company may sustain substantial costs in defending itself against these claims. Infineon intends to exert substantial efforts in defending itself against unfounded claims including the support of internal and external experts.

### Reorganization of our Memory Products segment

The proposed reorganization of our Memory Products segment – and any follow-up steps we may take – may impose unexpected burdens on our business and may not produce the benefits we expect.

In November 2005 our Supervisory Board approved a plan to restructure our Company in order to better prepare us to exploit market opportunities for our memory and logic businesses as and when they arise. The first step in this process will be a transfer of all of the assets and liabilities of our Memory Products segment into a separate, wholly owned subsidiary of Infineon

(this “drop-down” of assets and liabilities, or “Teilbetrieb”, is known as an “Ausgliederung” under German law). We expect that the transfer of the assets and liabilities of our Memory Products segment into a separate, wholly owned subsidiary of Infineon, will be completed by June 2006. We intend to monitor and evaluate financial and industry developments continuously during the 2006 financial year, and will consider further reorganization steps as appropriate.

The drop-down of the memory products business may be more difficult or expensive than we anticipate, and may require greater management time and other resources than expected, any of which could adversely affect our business or results of operations. These transactions will be extremely complex, and we may not be successful in executing them in the most efficient and cost-effective manner. In addition, any additional steps we may take following this initial reorganization may prove not to be the most strategically advantageous options available to us. This reorganization and related follow-up steps, if any, could adversely impact both our memory and our logic businesses. In any event, we may not realize all the benefits for each of our business lines that we intend to realize from these transactions.

### Overall risks

At no time during the past financial year have we been aware of any substantial risks which would have threatened the existence of the Company. Risks which may endanger the existence of the Company are currently not visible.

Additional descriptions relating to risks may be found in the notes to the consolidated financial statements included in this report as well as in the “Annual Report on Form 20-F”.

## INFINEON TECHNOLOGIES AG

Infineon Technologies AG is the parent company of the Infineon Group and carries out the Group's management and corporate functions. Infineon Technologies AG has major group-wide responsibilities such as finance and accounting, human resources, strategic and product-oriented research and development activities, as well as worldwide corporate and marketing communications. The responsibility for managing the flows of supplies, products, and services among the group companies is also handled by Infineon Technologies AG. Infineon Technologies AG has its own production facilities in Munich and Regensburg.

Infineon Technologies AG prepares its financial statements on a standalone basis in accordance with the requirements of the German commercial code (HGB). The complete financial statements are published separately.

Statements of operations <sup>1</sup> (condensed) € in millions			
As of September 30	2003	2004	2005
Net sales	8,122	8,852	<b>9,038</b>
Cost of goods sold	(7,201)	(7,325)	<b>(8,045)</b>
<b>Gross profit</b>	<b>921</b>	<b>1,527</b>	<b>993</b>
Operating expenses	(1,460)	(1,533)	<b>(1,483)</b>
Other income	252	136	<b>155</b>
<b>Income (loss) before tax</b>	<b>(287)</b>	<b>130</b>	<b>(335)</b>
Income tax	0	0	<b>(2)</b>
<b>Net (loss) income</b>	<b>(287)</b>	<b>130</b>	<b>(337)</b>
Accumulated loss brought forward	(1,052)	(1,339)	<b>(1,209)</b>
<b>Accumulated loss at end of year</b>	<b>(1,339)</b>	<b>(1,209)</b>	<b>(1,546)</b>

<sup>1</sup> Prepared in accordance with German GAAP (HGB).

During the financial year ended September 30, 2005, net sales decreased in the communications business group. In the memory products business group, net sales increased significantly. Sales in the 2005 financial year were also positively impacted by an increase in license income. Net loss for the year resulted in part from an increase in cost of sales and stronger price competition. Infineon Technologies AG handles the settlement of accounts for and with its subsidiaries that produce and sell products. As a result, Infineon Technologies AG's sales and cost of sales on a standalone basis were higher than those of the Infineon Group as a whole.

Net loss for the year was impacted by extraordinary allowances (€160 million) on investments and intellectual property, recorded pursuant to § 253 Abs. 2 S. 3 HGB, by credit

notes for prior years from Infineon Technologies Dresden GmbH & Co. OHG, Dresden (€82 million), and by collection of prior year's net income (€98 million) from Infineon Technologies SC 300 GmbH & Co. KG, Dresden.

Balance sheets <sup>1</sup> (condensed) € in millions		
As of September 30	2004	2005
Fixed and intangible assets	768	<b>718</b>
Investments	5,733	<b>6,182</b>
<b>Non-current assets</b>	<b>6,501</b>	<b>6,900</b>
Inventories	470	<b>463</b>
Receivables and other assets	1,992	<b>1,908</b>
Cash and marketable securities	2,395	<b>1,886</b>
<b>Current assets</b>	<b>4,857</b>	<b>4,257</b>
<b>Total assets</b>	<b>11,358</b>	<b>11,157</b>
Shareholders' equity	7,182	<b>6,845</b>
Accrued liabilities	798	<b>846</b>
Payables and other liabilities	3,378	<b>3,466</b>
<b>Total liabilities and shareholders' equity</b>	<b>11,358</b>	<b>11,157</b>

<sup>1</sup> Prepared in accordance with German GAAP (HGB).

Infineon Technologies AG's financial position showed an increase in investments, and a decrease in cash and marketable securities which was principally caused by our investments in SensoNor ASA, Infineon Technologies Finance GmbH and Inotera, partially offset by a capital decrease at Infineon Technologies Holding B.V., The Netherlands. The decrease in cash stems from operating business. The reduction in shareholders' equity results from the net loss for the year ended September 30, 2005. Infineon Technologies AG's shareholders' equity ratio was 61 percent (2003: 63 percent).

## Dividend

The standalone financial statements of Infineon Technologies AG, prepared in accordance with the HGB requirements for the 2004 financial year showed a net loss, therefore no dividend was distributed. A net loss was also incurred for the 2005 financial year and therefore a dividend cannot be distributed.

## Merger EUPEC

Effective October 1, 2005, EUPEC Europäische Gesellschaft für Leistungshalbleiter mbH, Warstein-Belecke was merged with Infineon Technologies AG, Munich.

## SUBSEQUENT EVENTS

In November 2005, our Supervisory Board approved a plan to transfer the assets and liabilities of our Memory Products segment into a separate, wholly owned subsidiary of our Company (this "drop-down" of assets and liabilities, or "Teilbetrieb", is known as an "Ausgliederung" under German law).

## OUTLOOK

Industry experts forecast mid-single-digit growth for the worldwide semiconductor market in the 2006 calendar year. For the 2006 financial year, we expect to develop at least in line with the market. In our Automotive, Industrial and Multimarket segment, we anticipate further growth due to increasing demand for electronics in cars, power conversion, and energy-saving technologies. In addition, we expect further business opportunities in the Communication segment, mainly due to our capability in radio frequency technologies. In our Memory Products segment, we will continue to focus our portfolio on higher margin growth businesses.

In the first quarter of the 2006 financial year, we expect revenues to increase slightly compared to the fourth quarter of the 2005 financial year. We will continue to phase out the production at Munich-Perlach, to build the new production site in Kulim, Malaysia, and to ramp-up the 300-millimeter production facility in Richmond. In addition, in the first quarter of the 2006 financial year we will begin to recognize stock-based compensation expense in our consolidated statement of operations.

In November 2005, our Supervisory Board approved a plan to separate the memory products business and to form a wholly owned subsidiary of our Company effective July 1, 2006. It is the preferred plan of our management to subsequently move towards a public offering of shares in this business.

For the first quarter of the 2006 financial year, we anticipate the following with respect to our three operating segments:

- In our Automotive, Industrial and Multimarket segment, we expect revenues and EBIT to increase slightly in the automotive and industrial business in the first quarter of the 2006 financial year compared to the fourth quarter of the 2005 financial year, despite annual price reductions at major customers that take effect for the first time in the first quarter of the 2006 financial year. We anticipate revenues and EBIT in the security and chip-card business to remain under pressure, but expect the trend to reverse beginning with the second quarter of the 2006 financial year, due to the cost reduction measures put in place. In the overall Automotive, Industrial and Multimarket segment, we expect revenues to increase slightly and EBIT margin to remain stable compared to the fourth quarter of the 2005 financial year, despite the mentioned price reductions, the anticipated expenses in connection with the planned phase-out of production at Munich-Perlach, and expenses for the new production site in Kulim, Malaysia.
- In the first quarter of the 2006 financial year, we expect revenues in our Communication segment to remain stable compared to the fourth quarter of the 2005 financial year. We anticipate the segment's EBIT loss to stay in the range of the EBIT loss in the fourth quarter of the 2005 financial year.
- In our Memory Products segment, we expect seasonal strength in demand for computers to drive bit-growth in the DRAM market in the first quarter of the 2006 financial year. On the supply side, capacity and productivity in the industry are expected to grow, offset only partially by capacity shifts to non-DRAM products by some of our competitors. This, coupled with pricing pressure and uncertainties regarding chipset availability in the PC segment, makes price development difficult to predict. We expect to further grow our bit production based on additional capacities at our joint venture Inotera and our 300-millimeter production facility in Richmond. We continue to focus our portfolio on higher margin growth businesses, including infrastructure, and high-end graphics, as well as consumer and mobile applications.