ZyXEL Communications Corp.
and Subsidiaries

Consolidated Financial Statements

December 31, 2013 and 2012
(With Independent Auditors' Report Thereon)

Independent Auditors' Report

The Board of Directors
ZyXEL Communications Corp.:

We have audited the accompanying consolidated balance sheets of ZyXEL Communications Corp. (ZyXEL) and subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of ZyXEL's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of certain subsidiaries included in the consolidated financial statements. Those financial statements were audited by other auditors. Therefore, in our audit report, the amounts related to the financial statements of those subsidiaries are based on the reports of other auditors. The total assets of those subsidiaries were $93,259 thousand (1.2% of consolidated total assets) as of December 31, 2012, and their total revenue was $98,515 thousand (0.9% of consolidated total revenue) for the year ended December 31, 2012.

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

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ZyXEL Communications Corp. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended, in conformity with the related financial accounting standards of the Business Entity Accounting Act and of the Regulation on Business Entity Accounting Handling, and accounting principles generally accepted in the Republic of China.

Hsinchu, Taiwan (the Republic of China)
March 11, 2014

ZyXEL Communications Corp. and Subsidiaries

Consolidated Balance Sheets

December 31, 2013 and 2012

(In thousands of New Taiwan dollars)

Assets	2013 Amount	%	2012 Amount	%
Current assets:				
Cash (note 4)	$ 2,865,656	33	2,129,924	27
Financial assets measured at fair value – current (note 5)	14,570	-	9,634	-
Available-for-sale financial assets – current (note 5)	-	-	71,857	1
Notes and accounts receivable, net (note 6)	2,525,927	29	2,196,759	27
Other receivables – related parties (note 16)	271,526	3	248,332	3
Other financial assets – current (note 5)	62,183	1	34,834	-
Inventories (note 7)	1,225,027	14	1,812,190	23
Other current assets	211,501	2	60,257	1
Deferred income tax assets – current (note 13)	115,055	2	153,728	2
Held-to-maturity financial assets – current (note 5)	-	-	4,299	-
	7,291,445	84	6,721,814	84
Investments:				
Available-for-sale financial assets – non-current (note 5)	175,617	2	133,825	2
Financial assets carried at cost – non-current (note 5)	83,638	2	109,211	1
	259,255	4	243,036	3
Property, plant and equipment:				
Cost:				
Land	33,990	-	33,117	-
Buildings and improvements	404,637	5	415,171	5
Machinery and equipment	92,853	1	89,919	1
Research and development equipment	79,097	1	68,359	1
Office and other equipment	172,108	2	163,168	3
	782,685	9	769,734	10
Less: accumulated depreciation	(357,991)	(4)	(334,798)	(4)
Prepayment for equipment	1,663	-	191	-
	426,357	5	435,127	6
Intangible Assets(note 9)	78,349	1	-	-
Other assets:				
Refundable deposits	33,350	-	33,534	-
Deferred expenses (note 8)	25,031	-	34,729	-
Deferred income tax assets – non-current (note 13)	48,377	1	100,480	2
Restricted deposits (note 16)	355,246	4	353,147	4
Prepaid pension cost (note 11)	88,098	1	85,259	1
	550,102	6	607,149	7
Total assets	$ 8,605,508	100	8,007,126	100

Liabilities and Stockholders' Equity	2013 Amount	%	2012 Amount	%
Current liabilities:				
Short-term borrowings (note 10)	$ 29,942	-	-	-
Financial liabilities measured at fair value – current (note 15)	29,107	-	5,653	-
Notes and accounts payable	748,227	9	443,407	6
Accounts payable – related parties(note 16)	471,437	5	451,483	6
Unearned sales revenue	19,141	-	11,410	-
Reserve for after-sales service	136,886	2	264,791	3
Accrued expenses and other current liabilities	681,095	8	595,799	7
	2,115,835	24	1,772,543	22
Other liabilities:				
Accrued pension liabilities (note 11)	872	-	1,108	-
Deposits received	3,051	-	2,969	-
	3,923	-	4,077	-
Total liabilities	2,119,758	24	1,776,620	22
Stockholders' equity (note 12)**:**				
Equity attributable to parent company stockholders				
Common stock	1,809,669	21	1,809,669	23
Capital surplus:				
Additional paid-in capital in excess of par value	1,173,093	14	1,173,093	15
Employee stock options	8,541	-	7,436	-
	1,181,634	14	1,180,529	15
Retained earnings:				
Legal reserve	1,494,092	17	1,494,092	19
Unappropriated earnings	1,922,743	22	1,709,364	21
	3,416,835	39	3,203,456	40
Other adjustments to stockholders' equity:				
Cumulative translation adjustment	(28,689)	-	(56,726)	(1)
Unrecognized pension cost	(2,338)	-	(2,421)	-
Unrealized gains on financial instruments	54,755	1	23,686	-
	23,728	1	(35,461)	(1)
Parent company stockholders' equity	6,431,866	75	6,158,193	77
Minority interest	53,884	1	72,313	1
Total stockholders' equity	6,485,750	76	6,230,506	78
Commitments and contingencies (notes 16 and 18)				
Total liabilities and stockholders' equity	$ 8,605,508	100	8,007,126	100

See accompanying notes to consolidated financial statements.

ZyXEL Communications Corp. and Subsidiaries

Consolidated Statements of Operations

Years ended December 31, 2013 and 2012

(In thousands of New Taiwan dollars, except for earnings per common share)

	2013		2012	
	Amount	%	Amount	%
Sales (note 16)	$ 12,119,496	105	11,770,754	103
Less: sales returns and allowances	543,121	5	394,061	3
	11,576,375	100	11,376,693	100
Cost of goods sold (notes 7 and 16)	9,088,966	78	9,330,980	82
Gross profit	2,487,409	22	2,045,713	18
Operating expenses (note 16):				
Selling	1,263,652	11	1,165,442	10
General and administrative	611,339	5	560,671	5
Research and development	543,975	5	491,643	4
	2,418,966	21	2,217,756	19
Operating income (loss)	68,443	1	(172,043)	(1)
Non-operating income and gains:				
Interest income (note 16)	16,751	-	20,234	-
Dividend income	1,991	-	13,010	-
Gain on disposal of investment, net (note 5)	57,785	-	-	-
Foreign exchange gain, net	182,451	2	-	-
Rent income	6,981	-	12,720	-
Gain on valuation of financial assets (note 5)	890	-	280	-
Grant revenues	9,240	-	9,057	-
Other income	25,950	-	20,268	-
	302,039	2	75,569	-
Non-operating expenses and loss:				
Interest expense	1,548	-	1,413	-
Loss on disposal of property, plant and equipment	2,076	-	3,816	-
Loss on disposal of investment, net (note 5)	-	-	37,214	-
Foreign exchange loss, net	-	-	83,429	1
Loss on valuation of financial liabilities (note 15)	29,107	-	5,653	-
Loss on impairment of goodwill (note 5)	-	-	1,484	-
Loss on disposal of held-to-maturity financial assets (note 5)	1,142	-	-	-
Other loss	19,908	-	9,231	-
	53,781	-	142,240	1
Income (loss) before income taxes	316,701	3	(238,714)	(2)
Income tax expenses (note 13)	100,227	1	110,119	1
Consolidated net income (loss)	**$ 216,474**	**2**	**(348,833)**	**(3)**
Attributable to:				
Shareholders of the parent	$ 213,379	2	(351,783)	(3)
Minority interest	3,095	-	2,950	-
	$ 216,474	**2**	**(348,833)**	**(3)**

	2013 Before taxes	2013 After taxes	2012 Before taxes	2012 After taxes
EPS (in New Taiwan dollars) (note 14)				
Basic EPS	**$ 1.52**	**1.18**	**(1.68)**	**(1.94)**

See accompanying notes to consolidated financial statements.

ZyXEL Communications Corp. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2013 and 2012
(In thousands of New Taiwan dollars)

	Common stock	Capital surplus	Retained Earnings: Legal reserve	Retained Earnings: Unappro-priated earnings	Cumulative translation adjustment	Net loss not recognized as pension costs	Unrealized gain and loss on financial instruments	Minority interest	Total stockholders' equity
Balance at January 1, 2012	$ 1,809,669	1,176,951	1,331,713	3,182,651	(50,363)	(2,088)	167,924	64,964	7,681,421
Allocation of net income									
Legal reserve	-	-	162,379	(162,379)	-	-	-	-	-
Common stock cash dividend	-	-	-	(959,125)	-	-	-	-	(959,125)
Write-off of treasury stock by parent company	-	-	-	-	-	-	90,032	-	90,032
Cost of stock options awarded by Unizyx to employees of subsidiaries	-	3,578	-	-	-	-	-	-	3,578
Unrealized loss on available-for-sale financial assets	-	-	-	-	-	-	(50,018)	-	(50,018)
Gain on disposal of available-for sale financial assets of subsidiaries	-	-	-	-	-	-	(185,086)	-	(185,086)
Net change in unrecognized pension costs of subsidiaries	-	-	-	-	-	(333)	-	-	(333)
Net change in unrealized gain on financial instruments of subsidiaries	-	-	-	-	-	-	834	-	834
Foreign currency translation adjustments	-	-	-	-	(6,363)	-	-	690	(5,673)
Increase in minority interest	-	-	-	-	-	-	-	3,709	3,709
Net income (loss) for 2012	-	-	-	(351,783)	-	-	-	2,950	(348,833)
Balance at December 31, 2012	1,809,669	1,180,529	1,494,092	1,709,364	(56,726)	(2,421)	23,686	72,313	6,230,506
Cost of stock options awarded by Unizyx to employees of subsidiaries	-	1,105	-	-	-	-	-	-	1,105
Gain on disposal of available-for sale financial assets of subsidiaries	-	-	-	-	-	-	(40,707)	-	(40,707)
Net change in unrealized gain on financial instruments of subsidiaries	-	-	-	-	-	-	71,776	-	71,776
Net change in unrecognized pension costs of subsidiaries	-	-	-	-	-	83	-	-	83
Foreign currency translation adjustments	-	-	-	-	28,037	-	-	(3,884)	24,153
Cash Dividend to minority interest	-	-	-	-	-	-	-	(17,640)	(17,640)
Net income for 2013	-	-	-	213,379	-	-	-	3,095	216,474
Balance at December 31, 2013	$ 1,809,669	1,181,634	1,494,092	1,922,743	(28,689)	(2,338)	54,755	53,884	6,485,750

See accompanying notes to consolidated financial statements.

ZyXEL Communications Corp. and Subsidiaries

Consolidated Statements of Cash Flows

Years ended December 31, 2013 and 2012

(in thousands of New Taiwan dollars)

	2013	2012
Cash flows from operating activities:		
Consolidated net income (loss)	$ 216,474	(348,833)
Adjustments:		
Depreciation	67,980	64,471
Amortization	15,285	29,867
Provision of allowance for doubtful accounts	29,302	11,439
Compensation cost arising from the parent company's stock transferred to employees	1,105	3,578
Provision for inventory obsolescence	99,333	28,525
Loss (gain) on disposal of investment	(57,785)	37,214
Loss on disposal of property, plant and equipment	2,076	3,816
Loss on disposal of held-to-maturity financial assets	1,142	-
Loss on impairment of goodwill	-	1,484
Loss on valuation of financial assets and liabilities measured at fair value	28,217	5,373
Net change in operating assets and liabilities:		
Financial assets measured at fair value – current	(9,699)	(6,000)
Notes and accounts receivable	(359,171)	395,699
Other receivables – related parties	(26,354)	(1,492)
Inventories	484,060	(245,026)
Prepayment	(74,035)	(13,268)
Other financial assets and other current assets	(63,737)	25,376
Deferred income tax assets	85,034	32,167
Notes and accounts payable (including related parties)	324,774	373,513
Unearned sales revenue, accrued expenses and other current liabilities	(34,878)	13,408
Other payables – related parties	-	(211,707)
Prepaid pension cost and accrued pension liabilities	(2,992)	(2,765)
Cash provided by operating activities	726,131	196,839
Cash flows from investing activities:		
Decrease (increase) in other receivables – related parties	3,160	(196,840)
Disposal of available-for-sale financial assets	61,021	211,107
Disposal of financial assets carried at cost	34,785	-
Acquisition of available-for-sale financial assets	-	(61,159)
Disposal and redemption of held-to-maturity financial assets	3,157	7,334
Receipt of cash from transfer of available-for-sale financial assets	-	53
Return of capital from financial assets carried at cost	7,866	21,400
Acquisition of property, plant and equipment	(61,063)	(23,917)
Disposal of property, plant and equipment	-	5,648
Decrease in refundable deposits	184	14,313
Acquisition of deferred expenses	(6,540)	(11,344)
Increase in restricted deposits	(2,099)	(9,468)
Acquisition of intangible assets	(77,671)	-
Cash used in investing activities	(37,200)	(42,873)

(Continued)

See accompanying notes to consolidated financial statements.

ZyXEL Communications Corp. and Subsidiaries

Consolidated Statements of Cash Flows (Continued)

Years ended December 31, 2012 and 2011

(in thousands of New Taiwan dollars)

	2013	2012
Cash flows from financing activities:		
Increase (decrease) in short-term borrowings	29,942	(9,025)
Increase (decrease) in deposits received	82	(1,270)
Cash dividends to minority interest	(17,640)	-
Cash dividends	-	(959,125)
Increase in minority interest	-	3,709
Cash provided by (used in) financing activities	12,384	(965,711)
Effect of exchange rate changes on cash	34,417	(9,371)
Net increase (decrease) in cash	735,732	(821,116)
Cash at beginning of year	2,129,924	2,951,040
Cash at end of year	$ **2,865,656**	**2,129,924**
Supplemental disclosures of cash flow information:		
Cash payments of interest	$ **1,548**	**1,413**
Cash payments of income taxes	$ **45,873**	**36,519**
Cash of disposal of available-for-sale financial assets:		
Disposal of available-for-sale financial assets	$ 101,842	-
Accounts receivable on disposal of available-for-sale financial assets	(40,821)	-
Cash received	$ **61,021**	-

See accompanying notes to consolidated financial statements.

ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

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

1. Organization and Principal Activities

ZyXEL Communications Corp. ("ZyXEL") was incorporated on August 16, 1989, at the Hsinchu Science-based Industrial Park. The shares of ZyXEL have been traded on the Taiwan Stock Exchange (TSE) since August 12, 1999. ZyXEL's main activities include the research, development, production and sale of high-speed multi-mode modems and application-specific chipsets (ASICs), secure telephones, network modems, digital video coders and decoders, wide area networks (WANs), local area networks (LANs), and integrated service digital network (ISDN) equipment. In addition, it provides related consulting and design services and imports and exports related products.

In order to increase operating efficiency, implement the policies on holding companies and separation of functions, and enhance market competitiveness, the board of directors of ZyXEL resolved on March 23, 2010, to form a new holding company – Unizyx Holding Co., Ltd. (Unizyx). The resolution was approved by the shareholders' meeting on June 17, 2010. Unizyx began operations on August 16, 2010. As Unizyx was set up to hold ZyXEL's group of communications businesses, ZyXEL became a 100%-held subsidiary of Unizyx through a share swap. In compliance with the Business Mergers and Acquisitions Act, ZyXEL exchanged one share of its common stock for each share of Unizyx for the shareholders of ZyXEL. Unizyx became the surviving listed company on the TSE, replacing ZyXEL. The effective date for the stock swap was August 16, 2010, and it was registered with the Securities and Futures Bureau (SFB) and TSE on July 21, 2010. The stock of ZyXEL stopped being publicly traded on September 2, 2010, as approved by the SFB.

As approved by the board of directors' meeting on October 15, 2010, MitraStar Technology Corporation (MitraStar), an OEM/ODM Business Unit of ZyXEL, was spun off from ZyXEL and became a 100%-held subsidiary of Unizyx on January 1, 2011. ZyXEL and MitraStar will focus and optimize their operations in different areas of the communication product value chain, with one focusing on ZyXEL brand communication product marketing and sales, and the other concentrating on communication technology development and product manufacturing. The focused and optimized operation of each subsidiary is expected to increase the overall efficiency of the ZyXEL group.

2. Summary of Significant Accounting Policies

The accompanying consolidated financial statements are prepared in accordance with the Business Entity Accounting Act, the Regulation on Business Entity Accounting Handing, and the accounting principles generally accepted in the Republic of China (ROC). The major accounting policies and measurement bases adopted in preparing the accompanying consolidated financial statements are summarized as follows:

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ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

(1) Spin-off

Unizyx spun off a product segment to form MitraStar, and owned all shares of MitraStar. The cost of investment in MitraStar is recognized as the net assets (less any asset impairment) minus liabilities of MitraStar. No exchange gain or loss is recognized.

(2) Overview of consolidated entities

(a) The consolidated subsidiaries of ZyXEL are summarized below:

Investor	Investee	Nature of Business	Percentage of the ownership at December 31, 2013	2012
ZyXEL	ZyChamp Investment Co., Ltd. (ZyChamp)	Investment	100%	100%
ZyXEL	ZyXEL Communications Inc.	Machining, assembly, development and sales of network products	100%	100%
ZyXEL	ZyXEL Communications A/S (ZyXEL Denmark) (note)	Sales and Marketing	100%	100%
ZyXEL	ZyXEL Singapore Private Limited	Sales and Marketing	100%	100%
ZyXEL	ZyFLEX Communications Inc.	Manufactures, development and sales of communication and network products	100%	100%
ZyXEL	Victor Blue Ltd. (Victor)	Investment	100%	100%
ZyXEL	ZyTPE Communications Corporation	Sales and Marketing	100%	100%
ZyXEL	ZyXEL Korea Co., Ltd.	Sales and Marketing	65%	65%
ZyXEL	Sphairon GmbH (a ZyXEL company)	Development of communication and network products	100%	-
Victor	Tianjin Huagin Communications Equipment Co., Ltd.	Manufactures and sales of communication and network products	95%	95%

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ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

Investor	Investee	Nature of Business	Percentage of the ownership at December 31, 2013	2012
Victor	ZyXEL Costa Rica, S.A.	Sales and Marketing	100%	100%
Victor	ZyXEL Malaysia SDN BHD	Sales and Marketing	100%	100%
Victor	ZyXEL Thailand Co., Ltd.	Sales and Marketing	51%	51%
Victor	ZyXEL Communications (Shanghai) Corp.	Sales of communication and network products	100%	100%
Victor	ZyXEL Iletisim Teknolojileri A.S.	Sales and Marketing	100%	100%
Victor	ZyXEL Pakistan (Pvt.) Ltd.	Sales and Marketing	90%	90%
Victor	ZyXEL Technology India Pvt Ltd.	Sales and Marketing	100%	100%
Victor	ZyXEL Technology Middle East FZE	Sales and Marketing	100%	-
ZyXEL Denmark	ZyXEL Deutschland GmbH	Sales and Marketing	100%	100%
ZyXEL Denmark	ZyXEL Communcations UK Ltd.	Sales and Marketing	100%	100%
ZyXEL Denmark	ZyXEL Communications Czech s.r.o.	Sales and Marketing	100%	100%
ZyXEL Denmark	ZyXEL Communications B.V.	Sales and Marketing	100%	100%

Note: ZyXEL Denmark included the Sweden, Finland, Norway and Spain branches.

Employees of ZyXEL and the subsidiaries stated above as of December 31, 2013 and 2012, numbered 1,159 and 1,001, respectively.

(b) Change in subsidiaries included in the consolidated financial statements:

ZyXEL established a joint venture, ZyXEL Korea Co., Ltd., on October 1, 2012 and owned 65% of the shares to expand the market for ZyXEL brands and increase its share of the telecom market in Korea, and it was included in the consolidated financial statements since its inception.

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For the purpose of expanding the European market, ZyXEL set up a new 100% owned subsidiary, Sphairon GmbH (a ZyXEL company), in April 2013, and it was included in the consolidated financial statements since its inception.

For the purpose of expanding the Middle East market, ZyXEL set up a new 100% owned sub-subsidiary, ZyXEL Technology Middle East FZE, in October 2013, and it was included in the consolidated financial statements since its inception.

(3) Basis of consolidation

The consolidated financial statements include the accounts of ZyXEL and its subsidiaries in which ZyXEL directly or indirectly owns over 50% of the voting shares and is able to exercise control over the subsidiaries' operations and financial policies. ZyXEL and such subsidiaries are referred to individually or collectively as "the Company". All significant inter-company transactions and balances are eliminated in consolidation.

(4) Use of estimates

The preparation of the accompanying consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosures of contingent liabilities. Actual results could differ from these estimates.

(5) Foreign currency transactions and translation

Non-derivative foreign currency transactions are recorded at the exchange rates prevailing on the transaction date. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies are translated using the exchange rates on that date. The resulting exchange gains or losses from settlement of such transactions or translation of foreign-currency-denominated monetary assets or liabilities are reflected as non-operating gains or losses in the accompanying consolidated statements of operations.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rates at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated into New Taiwan dollars at the rates ruling at the balance sheet date. If the non-monetary assets or liabilities are measured at fair value through profit or loss, the resulting unrealized exchange gains or losses from such translations are recorded in current profit or loss. If the non-monetary assets or liabilities are measured at fair value through stockholders' equity, then the resulting unrealized exchange gains or losses from such translations are recorded as a separate component of stockholders' equity.

Entities included in the consolidated financial statements record transactions in their respective local currencies which are their functional currencies. Remeasurement of the foreign financial statements into the functional currency is performed first, and the remeasuring differences are accounted for as exchange gains or losses in the statements of operations. The financial

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

(6) Principles of classifying assets and liabilities as current and noncurrent

Cash, assets held for the purpose of trading, and assets that will be held for a short time period and are expected to be converted to cash within 12 months from the balance sheet date are presented as current assets; all other assets are presented as noncurrent assets.

Liabilities that are incurred for the purpose of trading or are expected to be liquidated within 12 months after the balance sheet date are reflected as current liabilities; all other liabilities are reflected as noncurrent liabilities.

(7) Asset impairment

The Company assesses at each balance sheet date whether there is any indication that an asset (excluded goodwill, including individual asset or cash-generating unit) may have been impaired. If any such indication exists, the Company estimates the recoverable amount of the asset. The Company recognizes impairment loss for an asset whose carrying value is higher than the recoverable amount. The Company reverses an impairment loss recognized in prior periods for assets other than goodwill if there is any indication that the impairment loss recognized no longer exists or has decreased. The carrying value after the reversal should not exceed the recoverable amount or the depreciated or amortized balance of the assets assuming no impairment loss was recognized in prior periods.

(8) Financial assets and liabilities

(a) Financial assets and liabilities measured at fair value:

Financial assets and liabilities measured at fair value are held with the intention of buying and selling them in a short period of time. Except for those that the Company holds for hedging purposes and are considered to be effective hedging instruments, financial derivatives are classified into this account.

(b) Financial assets carried at cost:

Financial instruments whose fair values could not be measured with reasonable certainty are measured at their initial cost. However, if there is any objective evidence of impairment, a loss should be recognized thereon. Thereafter, the loss could not be reversed.

(c) Available-for-sale financial assets:

(Continued)

ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

These are measured at fair value, and any changes, excluding impairment loss and unrealized foreign currency exchange gain or loss, are reported as a separate component of stockholdersa loss should be recognizeds on financial instruments is realized. Realized gain or loss on financial instruments is charged to current operations. If there is objective evidence of impairment, an impairment loss is recognized in profit or loss. If, in a subsequent period, events or changes in circumstances indicate that the amount of impairment loss has decreased, the previously recognized impairment loss for equity securities is reversed to the extent of the decrease and recorded as an adjustment to equity, while for debt securities, the reversal is allowed through profit or loss provided that the decrease is clearly attributable to an event which occurs after the impairment loss is recognized.

(d) Held-to-maturity financial assets:

Financial assets which the Company has a positive intention and ability to hold to maturity are categorized as held-to-maturity financial assets and are carried at amortized cost. Those financial assets are initially recognized at fair value plus transaction costs that are directly attributable to the acquisition. Gains or losses are recognized at the time of derecognition, impairment or amortization. A regular way purchase or sale of financial assets is accounted for using transaction-date accounting.

Such financial assets are measured at amortized cost. However, if there is any objective evidence of impairment, a loss should be recognized thereon. If the impairment amount decreases in the future and it is apparently related to events happening after the recognition of impairment, the loss should be reversed and reflected in income or loss of that period. There is a restriction that the reversed amount could not result in the book value exceeding cost after amortization if there is no impairment.

(e) Notes, accounts and other receivables

Notes and accounts receivable are the creditors cost. However, if there is any objective evidence of impairment, a loss should be recognized thereon. If the

Concerning financial assets, the Company first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

Impairment loss is recognized and measured as the difference between the assetdence of impairment exists individually for financial assets that are individually at the financial asset’s original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account. The impairment loss is recognized in profit or loss. The present value of estimated future cash flows includes the recoverable amount of collateral and insurance.

(Continued)

If, in a subsequent period, the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal shall be recognized in profit or loss.

(9) Inventories

The cost of inventories shall comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. The allocation of fixed production overheads to the finished goods and work in progress is based on the normal capacity of the production facilities. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. Inventories are measured at the lower of cost or net realizable value on an individual item basis. The cost of inventories is based on the weighted-average-cost principle. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses at the balance sheet date.

(10) Property, plant and equipment

Property, plant and equipment are stated at cost. Interest expenses which are incurred for the construction of equipment before its usable condition are capitalized and added to the cost. Costs associated with significant additions, improvements, and replacements to property, plant and equipment are capitalized. Repairs and maintenance are charged to expenses as incurred. In addition, gains or losses on the disposal of property, plant and equipment are accounted for as non-operating income or losses in the consolidated statement of operations.

Depreciation of property, plant and equipment of the Company is provided for by using the straight-line method over the estimated useful lives of the respective assets. At the end of each fiscal year, any changes in the remaining useful life, depreciation method, or salvage value are regarded as changes in accounting estimates. The useful lives of the main property, plant and equipment are as follows:

(a) Buildings: 30~40 years.

(b) Building improvements: 5~10 years.

(c) Machinery, and research and development equipment: 3~7 years.

(d) Office equipment and others: 3~10 years.

(11) Intangible assets – research and development

Expenditure on research is recognized as an expense when it is incurred, except for the recognition of goodwill or intangible assets in a business combination. An intangible asset arising from technology development is recognized if, and only if, the Company can demonstrate all of the following:

(Continued)

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) Its intention to complete the intangible asset and use or sell it.

(c) Its ability to use or sell the intangible asset.

(d) How the intangible asset will generate probable future economic benefits. Among other things, the Company can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

The amount of intangible assets not generated from internal is originally measured by cost. Continued after, it is measured at cost less accumulated amortization and accumulated impairment losses.

The amortized amount is measured at cost less residual value.

Amortization is recognized as an expense on a straight-line basis over the estimated useful lives (5 years) of intangible assets of the Company from the date that they are made available for use.

The Company has to revaluate residual value, and the amortization method and period at the end of each fiscal year, at least. Any changes in residual value, amortization method, or amortization period are regarded as changes in accounting estimates.

(12) Deferred expenses

The costs of computer software and technical know-how are presented under deferred expenses, and are amortized over periods ranging from two to five years on a straight-line basis or percentage-of-sales-quantity basis.

(13) Retirement plan

ZyXEL and its ROC subsidiaries established an employee non-contributory defined benefit retirement plan ("the Plan") covering all regular employees under the ROC Labor Standards Law. In accordance with the Plan, ZyXEL and its ROC subsidiaries' employees are eligible for retirement or are required to retire after meeting certain age or service requirements. Payments of retirement benefits are based on the years of service and the average salary for the six-month period before the employee's retirement. Each employee earns two months of salary for the first fifteen years of service, and one month of salary for each year of service thereafter. The maximum retirement benefit is 45 months of salary. In accordance with the requirements of the ROC Labor Standards Law, ZyXEL and its ROC subsidiaries have contributed monthly at the

(Continued)

rate of 2% of salaries and wages to a pension fund. However, ZyXEL suspended its contribution of pension fund which has been approved by the Department of Labor, Taipei City Government since September 2013 to August 2014.

For the Plan, ZyXEL and its ROC subsidiaries carry out an actuarial calculation of their pension obligation at year-end. Based on the actuarial calculation, ZyXEL and its ROC subsidiaries recognize a minimum pension liability and net periodic pension costs covering the service lives of the retirement plan participants, including current service cost, net obligation at transition, prior service cost, and pension gains or losses amortized on a straight-line basis.

Beginning July 2005, pursuant to the ROC Labor Pension Act (hereinafter referred to as the "New Act"), employees who elected to participate in the New Act or joined ZyXEL and its ROC subsidiaries after July 1, 2005, are covered by a defined contribution plan under the New Act. For these employees, ZyXEL and its ROC subsidiaries are required to make a monthly contribution at a rate no less than 6% of the employee's monthly wages to the employee's individual pension fund account at the ROC Bureau of Labor Insurance.

Under the New Act, ZyXEL and its ROC subsidiaries contribute 6% of each employee's monthly wages to the Bureau of Labor Insurance. Pension cost is recognized in the period when the contribution is made.

For employees hired by foreign subsidiaries which adopt defined contribution plans, pension costs are recognized in the period when the actual contributions are made.

(14) Employee bonuses and remuneration of directors and supervisors

Effective January 1, 2008, and in accordance with Interpretation No. (96) 052 issued by the Accounting Research and Development Foundation ("ARDF"), the Company estimates employee bonuses and remuneration of directors and supervisors and charges them to current operations, classified under cost of goods sold and operating expense, as appropriate. The difference, if any, between the amount approved by stockholders in the subsequent year and the amount estimated in the current-year financial statements is accounted for as a change in accounting estimate, and charged to profit or loss in the subsequent year.

(15) Share-based payment

The Company need not apply Republic of China Statement of Financial Accounting Standards ("ROC SFAS") No. 39 "Share-based Payment" retrospectively to the employee stock options that were granted before January 1, 2008. However, the pro-forma net income, earnings per share, and related information on the share-based payment must still be disclosed.

The Company used the intrinsic value method to recognize compensation cost for its employee stock options issued between January 1, 2004, and December 31, 2007, which is the difference between the market price of the stock and the exercise price of the employee stock option on the measurement date, in accordance with ARDF Interpretation Nos. (92) 070, 071 and 072.

(Continued)

Any compensation cost should be charged to expense over the employee vesting period and increase stockholders' equity accordingly.

The Company used the intrinsic value method to recognize compensation cost for its employee stock options issued prior to December 31, 2007, in accordance with ARDF Interpretation Nos. (92) 070, 071 and 072. However, the Company need to apply ROC SFAS No. 39 to the employee stock options that were amended after January 1, 2008. Those amended equity instruments are measured at their intrinsic value and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognized in profit or loss.

The capital increase by cash arising from the exercise of employee stock subscription rights commencing from January 1, 2008, is accounted for in accordance with ARDF Interpretation No. (96) 267. According to this Interpretation, compensation cost is calculated based on the option-pricing model on the grant date and is amortized over the vesting period. If the stock cannot be fairly evaluated before its public offering, the intrinsic value is used to recognize the compensation cost. The grant date is either the ex-rights date or the date of approval by the board of directors if approval from the board of directors is required.

According to ROC SFAS No. 39 and ARDF Interpretation No. (96) 267, for the share-based payment granted by a parent company to its subsidiary after January 1, 2008, the compensation cost should be evaluated by the fair value of the share-based instrument and amortized throughout the vesting period as salary expense.

(16) Treasury stock

ZyXEL adopted ROC SFAS No. 30 "Accounting for Treasury Stock" for the repurchase of outstanding stock, and recognizes it as treasury stock at cost. If the disposal price is more than the book value of treasury stock, the difference between them will be presented under capital surplus – treasury stock transactions. The difference will be offset with capital surplus resulting from transactions of the same sort of treasury stock if the book value is more than the disposal price. The difference will be charged to retained earnings if capital surplus is insufficient.

Upon retirement of treasury stock, the "capital stock" and "capital surplus – additional paid-in capital" are debited on a pro rata basis. If the book value exceeds the sum of the par value of capital stock and the premium on stock issuance, the difference is charged against capital surplus arising from the same class of treasury stock transactions, and the remainder, if any, is charged against retained earnings. If the book value is less than the sum of the par value of capital stock and the premium on stock issuance, the difference is credited to capital surplus arising from the same class of treasury stock transactions.

Since January 1, 2008, when treasury stock is transferred to employees as bonus, the Company measures compensation cost at the date of grant using an option pricing model and amortizes the compensation cost over the requisite service period. The grant date is the date when employees accept the grant of stock. If approval from the board of directors is required, the grant date is the date of approval by the board of directors.

(Continued)

This standard is also applicable to the situation where subsidiaries own the stock of ZyXEL. When recognizing gains or losses on investment and preparing consolidated financial statements, the Company treats ZyXEL stock held by subsidiaries as treasury stock.

In accordance with ARDF Interpretation No. (97) 017, share-based payments involving transfers of equity instruments of an entity's parent which are granted to the entity's employees by the entity should be treated as cash-settled share-based transactions. The liabilities from rendered services or acquired goods should be measured at fair value. ZyXEL measures the fair value of a liability on the balance sheet date and settlement date, and records any change in its fair value as profit or loss.

(17) Revenue recognition

Sales revenue is recognized when title to the products and the risks and rewards of ownership are transferred to the customers, which occurs principally at the time of shipment. Shipments of materials for outsourced processing services are not recognized as sales until the processed products are delivered to customers.

(18) Government grants

Income from government grants for research and development is consistently recognized based on actual costs incurred as a percentage of the expected total costs.

(19) Income taxes

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

When a change in the income tax rate is enacted, any deferred tax liability or asset should be recomputed accordingly in the period of change. The difference between the new amount and the original amount, that is, the effect of changes in the deferred tax liability or assets, should be reported as an adjustment to income tax expense (benefit) for income from continuing operations.

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

(Continued)

The Company's purchase of machinery and technology for the automation of production and expenditures for research and development and for training entitle the Company to tax credits that are recognized by using the flow-through method.

In accordance with the Article 40 of Business Mergers and Acquisitions Act, the Company has adopted its parent company, Unizyx, as the taxpayer to file a combined corporate income tax return and the 10% surtax on undistributed earnings from 2011.

The Company and subsidiaries firstly calculated their respective income tax provision according to SFAS No. 22 "Income Taxes" and reconciled the difference between the separate income tax returns and the combined final business income return. The differences were allocated to all combined entities on a reasonable, systematic and consistent basis and consequently to current year's income tax expense and deferred income tax expenses.

According to the ROC Income Tax Act, ZyXEL's and its ROC subsidiaries' earnings are subject to an additional 10 percent corporate income surtax if not distributed. This surtax is charged to income tax expense in the following year when the shareholders decide not to distribute the earnings.

(20) Earnings per common share

Earnings per common share are computed based on the weighted-average number of common shares outstanding during the year. Earnings per common share for the prior year are retroactively adjusted to reflect the effects of new shares issued by transferring capital surplus and retained earnings.

ZyXEL's employee stock options issued are regarded as potential common stock. Because ZyXEL has a complex capital structure, both basic and diluted earnings per share are disclosed. For diluted earnings per common share, net income and the weighted-average number of common shares outstanding during the year are adjusted to include the dilutive effects of the potential common shares, assuming that they are outstanding during the entire year.

3. Reasons for and Effect of Changes in Accounting Principles: None

4. Cash

	December 31,	
	2013	2012
Petty cash, checking accounts, and demand deposits	$ 1,400,173	1,898,911
Time deposits	1,465,483	231,013
	$ 2,865,656	2,129,924

(Continued)

5. Financial Assets

(1) Financial assets measured at fair value – current:

	December 31,	
	2013	2012
Financial assets held for trading:		
Beneficiary certificates – open-end fund	$ 14,570	9,634

The gain on valuation at fair value of financial assets held for trading was $172 and $280 for the years ended December 31, 2013 and 2012, respectively. The gain on disposal of financial assets measured at fair value was $718 for the year ended December 31, 2013.

(2) Available-for-sale financial assets – current:

	December 31,	
	2013	2012
Mediatek Inc.	$ -	45,697
MStar Semiconductor, Inc.	-	26,160
	$ -	71,857

ZyChamp held 2,284 thousand shares of Ralink Technologies Corp. (Ralink) stock. Ralink was merged into Mediatek Inc. (Mediatek) on October 21, 2011. Mediatek is the surviving company, and the shares of Ralink stopped trading in the public market. Zychamp exchanged 3.156 shares of Ralink stock for each share of Mediatek stock and acquired 724 thousand shares of Mediatek stock. ZyChamp disposed of 723 thousand shares of Mediatek stock, and gain on disposal of investment was $185,086, recorded as reduction of losses on disposal of investments, net.

ZyChamp acquired 297 thousand shares of MStar Semiconductor, Inc. (MStar) for $61,519 in July 2012. On August 14, 2012, the meeting of directors of MStar approved the plan for MStar to merge with Mediatek, wherein, the date was set for February 1, 2014. ZyChamp exchanged 0.794 share of MStar stock for each share of Mediatek stock and a cash of $1 (dollar). Mediatek is the surviving company. The exchange stock is a two-step process. ZyChamp exchanged 177 thousand shares of Mstar for 141 thousand shares of Mediatek and a cash of $53 in first step process.

In December 2013, ZyChamp disposed all the shares of Mediatek and MStar stock, and the gain on disposal of investment was $40,707, which included $40,821 on the disposal of the shares of MStar (recorded as the other financial assets – current) which was received in January 2014.

The original costs were $0 and $61,135, and the unrealized gains on financial instruments were $0 and $10,722 as of December 31, 2013 and 2012, respectively.

(Continued)

(3) Available-for-sale financial assets – non-current:

	December 31,	
	2013	2012
Unizyx	$ 175,617	133,825

On November 13, 2012, and May 3, 2011, the board of directors of Unizyx decided to write off 11,115 thousand and 14,613 thousand shares of treasury stock with a capital reduction date of November 19, 2012, and May 16, 2011, respectively, which resulted in a $222,300 and $292,260 loss, respectively.

ZyChamp held 4,630 thousand shares of ZyXEL amounting to $120,861. After the share swap, ZyChamp holds shares of Unizyx, accounted for as available-for-sale financial assets – non-current at the market value on the swap date. As of December 31, 2013, the treasury stock had increased to 9,391 thousand shares due to new shares issued by transferring retained earnings and had not yet been transferred. The treasury stock equaled $175,617 and $133,825 at fair value as of December 31, 2013 and 2012, respectively.

(4) Held-to-maturity financial assets – non-current:

	December 31,	
	2013	2012
Corporate bonds – Applied Vacuum Coating Technologies Co., Ltd. (AVCT)	$ -	4,299
Less: current portion	-	(4,299)
	$ -	-

ZyChamp bought four-year and three-year corporate bonds issued by AVCT with a face value of $25,000 and $7,200 in August 2008 and January 2009, respectively. The coupon rate of both bonds is 10%, and the maturity date was in September 2012 and January 2012, respectively. After AVCT amended the bonds' terms in September 2009, the bond period is five years and four years, respectively. The maturity date is in September 2013 and January 2013, respectively, and the coupon rate of both bonds is 10%. If the audited financial statements of AVCT show a profit for any quarter, the interest rate of the following quarter is reduced to 8%. However, if AVCT suffers a loss in the subsequent quarter, the interest rate would be raised to the original 10%.

ZyChamp made a redeem debt agreement in November 2013 that AVCT could pay its corporate bounds amounting to $1,382 by $240, and ZyChamp recognized a loss on disposal of $1,142. In addition, ZyChamp redeemed the above corporate bonds amounting to $2,917 and $7,334 on schedule in the years ended December 31, 2013 and 2012, respectively.

(Continued)

The above bond investments were acquired through a private offering and cannot be transferred to others except in the circumstances specified in Article 43-8 of the ROC Securities and Exchange Act.

(5) Financial assets carried at cost – non-current:

	December 31,			
	2013		2012	
Investee	Amount	Percentage of ownership	Amount	Percentage of ownership
Hong Pang Venture Capital Corp.	$ 33,150	10	39,000	10
Chien Pang Venture Capital Corp.	31,584	10	33,600	10
Homeyen Networks Inc.	11,985	17	11,985	17
Handlink Technology, Inc.	5,088	6	5,088	6
Essence Technology, Inc.	911	3	911	3
ZOWIE Technology Corporation	772	-	772	-
L7 Networks Inc.	148	1	148	1
Broad Web Corporation	-	-	17,707	12
Litek Opto-electronics Co., Ltd.	-	-	-	-
AccFast Technologies Corp.	-	5	-	5
Aetas Technology Inc.	-	1	-	1
	$ 83,638		109,211	

The above investments did not have quoted prices in an active market, and their fair value could not be reliably measured. Thus, they were classified under financial assets carried at cost.

As of December 31, 2013 and 2012, the Company's original costs for Hung Pang Venture Capital Corp. and Chien Pang Venture Capital Corp. were $64,734 and $72,600, respectively. The Company received a $7,866 and $21,400 refund due to the capital reduction of Hong Pang Venture Capital Corp. and Chien Pang Venture Capital Corp. in 2013 and 2012, respectively.

On October 29, 2013, Broad Web Corporation merged with Trend Micro Co., Ltd., and the Trend Micro Co., Ltd. is the surviving company. The special shareholders' meeting of Broad Web Corporation approved the merger and set November 30, 2013 as the acquisition date, the acquisition price was $34.2. According to the consolidated contract, Trend Micro Co., Ltd. offered an amount of $27.36 per share (80% total of the acquisition price) to the shareholders of Broad Web Corporation. Therefore, ZyChamp received $34,785, and recognized a gain on disposal investment of $17,078.

The rest value of the acquisition price was $6.84 per share (20%), which was turned into deposit as a guarantee of Broad Web's compliance on the assurances and obligations in the consolidated contract. If Broad Web Corporation breach the contract in two years (started from the acquisition date), Trend Micro Co., Ltd. can offset the loss from the deposit. Trend Micro Co., Ltd. will pay 10% (less the loss from the contract and plus interest) to the shareholders of Broad Web Corporation at the first and second year ended started from the acquisition date, respectively.

The abovementioned contingent fee of $8,698 depends on the performance of Broad Web Corporation. Therefore, ZyChamp will not recognize this part of gain on disposal investment under the material uncertainty until ZyChamp receives this amount.

ZyXEL established a joint venture, ZyXEL Korea Co., Ltd., in November 2012 and owned 65% of the shares to expand the market for ZyXEL brands and increase its share of the telecom market in Korea. The difference between investment cost and underlying equity in net assets was $1,484. The Company estimated that impairment losses were incurred and recognized an impairment loss in 2012.

6. Notes and Accounts Receivable, Net

	December 31,	
	2013	**2012**
Notes receivable	$ 3,712	5,764
Accounts receivable	2,620,983	2,238,487
	2,624,695	2,244,251
Less: Allowance for doubtful accounts	(61,302)	(32,701)
Allowance for sales discounts and returns	(37,466)	(14,791)
	$ 2,525,927	2,196,759

7. Inventories

	December 31,	
	2013	**2012**
Finished goods	$ 1,368,949	1,969,403
Less: Provision for devaluation	(238,965)	(246,529)
	1,129,984	1,722,874
Work in process and semi-finished goods	28,955	14,881
Less: Provision for devaluation	(4,127)	(667)
	24,828	14,214
Raw materials	116,267	113,066
Less: Provision for devaluation	(46,052)	(37,964)
	70,215	75,102
	$ 1,225,027	1,812,190

(Continued)

For the years ended December 31, 2013 and 2012, the Company recognized operating cost of $99,333 and $28,525, respectively, from the write-down of inventory costs to net realizable value.

8. Deferred Expenses

	December 31, 2013	December 31, 2012
Computer software	$ 25,031	34,527
Technical know-how	-	202
	$ 25,031	**34,729**

9. Intangible Assets

The costs of trade rights are presented under intangible assets, the cost and amortization in 2013 and 2012 are as follows:

	Operating Rights
Costs:	
Balance at January 1, 2013	$ -
Additions	77,671
Translation adjustment	3,163
Balance at December 31, 2013	**$ 80,834**
Accumulated amortisation:	
Amortisation for the year	$ 2,485
Balance at December 31, 2013	**$ 2,485**
Book value:	
Balance at December 31, 2013	**$ 78,349**

As of December 31, 2013, there is no intangible asset pledged.

10. Short-term Borrowings

	December 31, 2013		December 31, 2012	
	Amount	Interest rate %	Amount	Interest rate %
Unsecured borrowings	**$ 29,942**	**5.00%**	**-**	**-**

11. Retirement Plans

The Company assess their defined benefit retirement plans using the balance sheet date as the measurement date. The following table sets forth the benefit obligation and accrued pension liabilities for the defined benefit plans:

	December 31, 2013	December 31, 2012
Benefit obligation:		
Vested benefit obligation	$ 8,291	3,934
Nonvested benefit obligation	38,349	40,336
Accumulated benefit obligation	46,640	44,270
Projected future salary increase	16,203	22,125
Projected benefit obligation	62,843	66,395
Fair value of plan assets	(141,714)	(137,811)
Funded status	(78,871)	(71,416)
Unrecognized net loss	28	30
Unamortized pension loss	(10,721)	(15,186)
Additional accrued pension liabilities	2,338	2,421
Prepaid pension cost	**$ (87,226)**	**(84,151)**

Recorded as follows:

	December 31, 2013	December 31, 2012
Prepaid pension cost	$ (88,098)	(85,259)
Accrued pension liabilities	872	1,108
	$ (87,226)	**(84,151)**

The components of net periodic pension cost are summarized as follows:

	2013	2012
Defined benefit plan:		
Service cost	$ 231	784
Interest expenses	1,158	1,457
Actual returns on pension fund	(1,774)	(1,308)
Amortization	(477)	(943)
Net pension cost	**$ (862)**	**(10)**
Defined contribution plan	**$ 58,628**	**37,575**

(Continued)

Actuarial assumptions are summarized as follows:

	December 31,	
	2013	**2012**
Discount rate	1.75%	1.75%
Rate of increase in future compensation levels	2.00%~ 2.50%	2.00%~ 2.50%
Expected long-term rate of return on plan assets	1.75%	1.75%

As of December 31, 2013 and 2012, the vested benefit of employees meeting retirement requirements was $8,854 and $4,284, respectively.

12. Stockholderssers, 20

(1) Common stock

As of December 31, 2013 and 2012, ZyXEL's authorized common stock amounted to $6,000,000, of which $260,000 was for use as employee stock options, convertible preferred stock, or convertible corporate bonds. The issued common stock amounted to $1,809,669 with par value of $10 per share.

(2) Employee stock options

(a) As approved by a resolution of the board of directors' meeting of ZyXEL on November 26, 2010, in order to protect employee benefits, Unizyx, the parent company of ZyXEL, assumed the stock options issued by ZyXEL in December 2007 and replaced ZyXEL as the issuer of the options. According to ARDF Interpretation No. (96) 330 issued on December 14, 2007, for an entity that originally adopted the intrinsic value method and subsequently modified the terms or conditions of a share-based payment to which this statement has not been applied on or after January 1, 2008, the entity shall recognize the effects of modifications that increase the total fair value of the share-based payment and measure the equity instruments at their intrinsic value, initially at the date the entity obtains the goods or the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognized in profit or loss.

Pursuant to the above interpretation, due to the fair value of each stock option unit being less than the stock price at the modification date of the stock option plan, at December 31, 2013 and 2012, the compensation cost was zero.

ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

The exercise price of the employee stock option plan was based on the closing price of common stock of ZyXEL on the issue date and the exchange ratio of shares of the parent company, Unizyx. After the issuance of the employee stock options, the exercise price will be amended according to a specific formula if the total number of shares of common stock of Unizyx changes or Unizyx pays cash dividends.

In December 2007, the Securities and Futures Bureau ("SFB") approved ZyXEL's plan to issue 26,000,000 units of employee stock options. Each unit entitles the holder to subscribe for one common share of ZyXEL, and the option rights are valid for 5 years beginning from the grant date. The employee stock option rights that expired on December 24, 2012, were as follows:

Classification	Grant date	Grant period	Issued units	Exercise price per share (NT$)	Measure-ment date market price per share (NT$)	Revision date market price per share (NT$)	Dec. 31, 2013, market price per share (NT$)	Dec. 31, 2012, market price per share (NT$)	Adjusted exercise price per share (NT$)
Employee stock options in 2007	Dec. 25, 2007	Dec. 25, 2009~ Dec. 24, 2012	26,000,000	41.70	41.70	28.10	14.25	16.40	34.50

ZyXEL adopted the intrinsic value method to recognize the compensation cost for the employee stock options in 2007. However, as the option exercise price was equal to the market value on the measurement date, there was no compensation cost recognized.

If ZyXEL recognized compensation cost using the Black-Scholes option pricing model in accordance with ROC SFAS No. 39, the fair value of the options would be $10.6 (dollars) per unit, based on the following assumptions:

Expected dividend yield	2.59%
Expected volatility	33.51%
Risk-free interest rate	2.448%
Expected life	5 years

The employee stock option plan was modified on November 26, 2010, so that the fair value of the option was evaluated using the Black-Scholes model on that date, and the fair value of the options would equal approximately $0.1 (dollar) per unit. According to ROC SFAS No. 39, if a modification plan reduces the fair value of the equity component, the compensation cost still has to be calculated based on the original fair value. Therefore, the fair value was still $10.6 (dollars) per unit.

(Continued)

ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

Information related to ZyXEL's employee stock option plan is as follows:

	2012	
Employee stock options	**Options (thousands)**	**Weighted-average exercise price (NT$)**
Outstanding at beginning of year	26,000	37.20
Granted	-	-
Exercised	-	-
Forfeited	(26,000)	34.50
Outstanding at end of year	-	-
Outstanding exercisable employee stock options	-	

(b) Unizyx registered and issued 15,000,000 units of employee stock options in November 2010. Each unit can purchase one share of Unizyx. The duration of the plan is 5 years, and the plan was certified by the SFB. As of December 31, 2013, the related information on the plan was as follows:

Classification	Certified Date	Issuance Date	Issued Units (in thousands)	Grant period	Exercise price per share (NT$)	Adjusted exercise price per share (NT$)
Employee stock options in 2010	Nov. 26, 2010	Dec. 9, 2010	15,000	Dec. 9, 2012~ Dec. 8, 2015	29	25.9

Unizyx adopted ROC SFAS No. 39 and used the fair value method to recognize compensation costs. The estimated fair value of the options granted was $1.3~$2.0 (dollars) at the date of grant using the Black-Scholes option pricing model. As of December 31, 2013, the number of options which Unizyx had granted to employees of ZyXEL was 5,102 thousand units. For the years ended December 31, 2013 and 2012, ZyXEL recognized compensation cost of $1,105 and $3,578, respectively, with the following weighted-average assumptions:

Expected dividend yield	2.55%
Expected volatility	14.19%
Risk-free interest rate	0.45%~0.90%
Expected life	1~3 years

Information related to employee stock options that Unizyx granted to ZyXEL's employees is as follows:

	2013		2012	
Employee stock options	**Options (thousands)**	**Weighted-average exercise price (NT$)**	**Options (thousands)**	**Weighted-average exercise price (NT$)**
Outstanding at beginning of year	5,102	25.90	5,102	28.00
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding at end of year	**5,102**	**25.90**	**5,102**	**25.90**
Outstanding exercisable employee stock options	**3,827**		**2,551**	

As of December 31, 2013 and 2012, the weighted-average remaining contractual life of outstanding options was 1.94 years and 2.94 years, respectively.

(3) Capital surplus

From the year 2012, pursuant to the ROC Company Act, capital surplus should be used to offset a deficit first, and then the realized capital surplus can be converted into capital and distributed as stock dividends or distributed as cash dividends. The aforementioned realized capital surplus that was generated from the excess of the issuance price over the par value of the capital stock and donations received. However, capital surplus that originated from long-term equity investments accounted for by the equity method cannot be used to increase share capital or to offset a deficit.

(4) Legal reserve

From the year 2012, the ROC Company Act stipulates that companies must retain 10% of their annual net earnings, as defined in the Act, until such retention equals the amount of the issued share capital. When a company incurs no loss, it may, pursuant to a resolution to be adopted by the shareholders' meeting as required, distribute its legal reserve to shareholders by issuing new shares or distributing cash. Only the portion of the legal reserve which exceeds 25% of the paid-in capital may be distributed.

(Continued)

(5) Distribution of earnings and dividend policy

According to the amended articles of incorporation, in years of earnings, ZyXEL has to offset any accumulated deficit, pay income tax, and appropriate 10% of the balance as a legal reserve before distribution of earnings. The balance of the earnings may be distributed in the following order: no more than 2% should be distributed as the remuneration of the board of directors and supervisors, and the remaining earnings together with prior years' unappropriated earnings could be retained in accordance with a resolution of the shareholders' meeting or distributed as below after retaining part of the earnings:

(a) No less than 0.01% should be distributed as employee bonuses, and the bonuses could be either cash or stock. However, ZyXEL may issue stock to employees of subsidiaries for profit sharing.

(b) The rest of the earnings are shareholders' dividends.

Employee bonuses and remuneration of directors and supervisors were computed at 0.01% of ZyXEL's net income for the year ended December 31, 2013, after setting aside 10% as legal reserve. Because the amount was minor, ZyXEL did not recognize employee bonuses and remuneration of directors and supervisors in 2013.

On March 14, 2013 and May 8, 2012, the board of directors of ZyXEL approved the plan to offset the operating losses for year 2012 and the distribution of retained earnings for the year 2011, respectively, proposed by the board of directors. Information about ZyXEL's directors' and supervisors' remuneration and employee bonuses which were distributed from unappropriated earnings of 2011 is as follows:

		2011
Cash dividend per common share	**$**	**5.30**
Employee bonuses – cash	$	96
Directors' and supervisors' remuneration		-
	$	**96**

The actual distribution of employee bonuses was $96 in 2012, which was different from the original estimation in 2012, and it was recognized as a change in accounting estimation and recorded as expense for the year 2012.

(Continued)

13. Income Taxes

(1) ZyXEL's capital expansion plan to manufacture communication machinery and equipment (IP DSLAM, broadband exchangers, broadband connectors, broadband security equipment, wireless broadband local network equipment, ISDN routers, ISDN terminals, and analog modems) is consistent with the statute granting a five-year tax exemption to manufacturers and to companies in certain industries providing technical services, and its tax-exemption duration is as below:

	Duration of tax exemption
Ninth expansion	May 1, 2007 ~ April 30, 2012

ZyXEL's capital expansion plan to manufacture the digital-transmission equipment (Metro Ethernet urban Ethernet equipment) and microwave communication systems (WiMax global microwave receiving equipment) is consistent with the Statute for Newly Emerging, Important and Strategic Industries as it applies to manufacturers and to certain industries providing technical services, and its tax-exemption duration is as below:

	Duration of tax exemption
Tenth expansion	May 1, 2007 ~ April 30, 2012

According to the Business Mergers and Acquisitions Act, Article 37, for the abovementioned tax-free manufacturing equipment, which was originally owned by ZyXEL and was spun off to MitraStar, and MitraStar assumed the tax exemption benefit.

(2) For ZyXEL and its ROC subsidiaries, the statutory income tax rate is 17% in 2013 and 2012, and they are also subject to the Income Basic Tax Act. Starting 2011, in accordance with the Article 40 of the Business Mergers and Acquisitions Act, ZyXEL has adopted its parent company, Unizyx, as the taxpayer to file a consolidated corporate income tax return and pay the 10% surtax on undistributed earnings. The tax rates for the foreign subsidiaries of ZyXEL are based on the tax law of their local jurisdiction.

The Company's income tax expense was as follows:

	2013	2012
Current	$ 20,174	27,521
Deferred	79,691	32,167
Additional 10% surtax on undistributed earnings	362	50,431
	$ 100,227	**110,119**

(Continued)

ZyXEL Communications Corp. and Subsidiaries

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(3) The reconciliation of the expected income tax expense at the statutory tax rate and the actual income tax expense was as follows:

		2013	2012
Income tax expense (benefit) computed at the statutory tax rate of 17%	$	53,839	(40,581)
Difference due to local tax rates of subsidiaries		6,440	15,206
Tax effect of investment tax credits expired		243,097	211,108
Tax effect of loss (gains) on disposal of investments		(6,853)	7,865
Change in valuation allowance		(218,570)	(127,992)
Prior-year adjustments and others		29,911	(23,321)
Tax combination effect		(12,777)	-
Additional 10% surtax on undistributed earnings		362	50,431
Income basic tax		4,778	17,403
Income tax expense	**$**	**100,227**	**110,119**

(4) The components of deferred income tax assets (liabilities) are summarized as follows:

		December 31,	
		2013	2012
Deferred tax assets – current:			
Investment tax credits	$	-	260,363
Loss carryforward		18,710	-
Unrealized profit on inter-company sales		22,529	35,831
Provision for uncollectible expenses in excess of limit		7,718	3,399
Warranty expense		14,127	39,143
Unrealized decline in value of inventories		57,516	39,484
Unrealized gain on exchange		(6,781)	(2,640)
Allowance for sales discounts and returns		6,345	6,084
Others		15,661	34,831
		135,825	416,495
Less: valuation allowance		(20,770)	(262,767)
	$	**115,055**	**153,728**
Deferred tax assets – non-current:			
Loss carryforward		86,464	111,093
Loss on overseas investment accounted for using equity method		57,645	59,424
Accrued pension cost		-	146
Prepaid pension cost		(14,977)	(14,494)
Cumulative translation adjustment		5,876	11,619
Others		10,645	6,541
		145,653	174,329
Less: valuation allowance		(97,276)	(73,849)
	$	**48,377**	**100,480**

(Continued)

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	December 31,	
	2013	2012
Total deferred tax assets	$ 303,236	607,958
Total deferred tax liabilities	$ 21,758	17,134
Total valuation allowance	$ 118,046	336,616

(5) Below is the reconciliation of ZyXEL's calculation of the current income tax expense, deferred income tax expense, deferred tax assets and receivables from /payables to related parties under the provisions of SFAS No. 22 "Income Taxes" to the related balances computed for filing final corporate income tax returns with Unizyx as the taxpayer:

	2013			
	Current income tax expense	Deferred income tax expense	Deferred tax assets	Other receivables related parties
Amount computed under SFAS No. 22	$ 33,313	79,691	168,774	814
Difference adjustment	(12,777)	-	(5,342)	18,119
Amounts computed for filing combined corporate income tax returns	$ 20,536	79,691	163,432	18,933

The accumulated loss of ZyXEL in 2012 was $127,774 which caused an income tax benefit of $12,777 under the combined filing of income tax. The deferred tax asset of the combined filing of income tax being used was $5,342 due to the loss carryforward of $31,424 in 2012. The above adjustments generated an other receivables – related parties amounted to $18,119.

Due to the combined filing of income tax (combining ZyXEL with Unizyx), the tax receivable for the year 2013 is recorded as other receivables – related parties.

(6) According to the ROC Income Tax Act amended in January 2009, the previous 10 years' losses of the Company's ROC subsidiaries as assessed by the tax authorities can offset the current year's net income for income tax purposes. As of December 31, 2013, the unused loss carryforwards and related expiration years of ZyXEL and ZyFLEX Communications Inc. were as follows:

Year of loss	Tax effect	Expiration year
2006	$ 22,703	2016
2007	97,393	2017
2009	10,169	2019
2011	130,380	2021
2012	273,117	2022
2013	84,910	2023
	$ 618,672	

(7) As of the December 31, 2013, ZyXEL's income tax returns had been examined by the tax authority through year 2010.

(8) Information related to the imputation credit account (ICA) of ZyXEL is summarized as follows:

	December 31,	
	2013	**2012**
Unappropriated earnings:		
Earned before December 31, 1997	$ 256,529	256,529
Earned after December 31, 1997	1,666,214	1,452,835
	$ 1,922,743	**1,709,364**
ICA balance	**$ 254,957**	**243,393**

	2013	2012
Creditable ratio for earnings distribution to resident stockholders	**15.30% (estimated)**	**16.75% (actual)**

(Continued)

ZyXEL Communications Corp. and Subsidiaries

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14. Earnings per Common Share

The calculations of basic earnings per share attributable to the stockholders of ZyXEL were as below.

	2013		2012	
	Before taxes	After taxes	Before taxes	After taxes
Basic earnings per common share:				
Net income (loss)	$ 275,953	213,379	(303,990)	(351,783)
Weighted-average common shares outstanding (thousand shares)	180,967	180,967	180,967	180,967
Basic earnings per common share (NT$)	$ 1.52	1.18	(1.68)	(1.94)

15. Financial Instruments

(1) The Company uses derivative instruments to hedge certain currency risk the Company is exposed to arising from its operating activities in 2013 and 2012. Because the Company does not qualify SFAS No.34, therefore, the hedge accounting is not used. The forward exchange agreements that were not settled as of December 31, 2013 and 2012 are as follows:

	2013.12.31			
	Notional amount (EUR thousand)	Currency	Duration of contract	Fair value
Sell forward foreign currency exchange contract	3,000	EUR exchange USD	102.08.02~ 103.01.02	$ (4,493)
Sell forward foreign currency exchange contract	3,000	EUR exchange USD	102.08.02~ 103.01.06	(4,509)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.08.02~ 103.01.06	(3,018)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.08.08~ 103.02.12	(2,933)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.08.09~ 103.02.12	(2,635)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.08.22~ 103.02.24	(1,912)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.08.26~ 103.02.27	(2,700)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.09.23~ 103.03.24	(2,479)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.09.23~ 103.03.24	(1,883)

(Continued)

	2013.12.31			
	Notional amount (EUR thousand)	Currency	Duration of contract	Fair value
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.10.03~ 103.04.03	$ (1,608)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	102.10.23~ 103.04.21	(622)
Sell forward foreign currency exchange contract	1,000	EUR exchange USD	102.10.24~ 103.04.24	(315)
Financial liabilities measured at fair value – current				$ (29,107)

	2012.12.31			
	Notional amount (EUR thousand)	Currency	Duration of contract	Fair value
Sell forward foreign currency exchange contract	4,000	EUR exchange USD	101.12.13~ 102.05.14	$ (2,255)
Sell forward foreign currency exchange contract	4,000	EUR exchange USD	101.12.13~ 102.05.14	(2,139)
Sell forward foreign currency exchange contract	2,000	EUR exchange USD	101.12.13~ 102.05.14	(1,011)
Sell forward foreign currency exchange contract	1,000	EUR exchange USD	101.12.25~ 102.05.28	(102)
Sell forward foreign currency exchange contract	1,000	EUR exchange USD	101.12.26~ 102.05.28	(102)
Sell forward foreign currency exchange contract	1,000	EUR exchange USD	101.12.27~ 102.06.03	(44)
Financial liabilities measured at fair value – current				$ (5,653)

For the years ended December 31, 2013 and 2012, for the sell forward foreign currency exchange contract transactions, unrealized valuation loss amounting to $29,107 and $5,653 was accounted for as financial liabilities measured at fair value – current.

(2) The Company’s non-derivative financial instruments’ fair values, including notes/accounts receivable (including related parties), other relievable – related parties, other financial assets – current, short-term borrowings, notes/accounts payable (including related parties), and other payables – related parties were determined based on their carrying values because of the short maturities of the instruments. The carrying amounts and estimated fair values of all other financial instruments were as follows:

(Continued)

	December 31,			
	2013		2012	
	Book value	Fair value	Book value	Fair value
Financial assets:				
Financial assets measured at fair value – current	$ 14,570	14,570	9,634	9,634
Available-for-sale financial assets – current	-	-	71,857	71,857
Available-for-sale financial assets – non-current	175,617	175,617	133,825	133,825
Financial assets held to maturity	-	-	4,299	4,299
Financial assets carried at cost	83,638	(3)(iii) below	109,211	(3)(iii) below
Refundable deposits	33,350	33,099	33,534	33,098
Restricted deposits	355,246	355,246	353,147	353,147
Financial liabilities:				
Financial liabilities measured at fair value – current	29,107	29,107	5,653	5,653
Deposits received	3,051	3,051	2,969	2,969

(3) The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

(i) The carrying amounts of notes and accounts receivable (including related parties), other receivables – related parties, other financial assets – current, short-term borrowings, notes and accounts payable (including related parties), and other payables – related parties approximate their fair value due to the short-term nature of these items.

(ii) The fair value of financial instruments is the active market quoted price if it is available. If the market price is unavailable, the Company will determine the fair value based on an evaluation method, and the estimates and assumptions incorporated in such evaluation are consistent with those used by market participants in their pricing of financial instruments. The above information is accessible to the Company. The discount rate used by the Company is equal to the rate of return of financial instruments having the same conditions and characteristics. Their conditions and characteristics include the credit status of the debtor, the remaining period of the fixed interest rate specified in the contract, the remaining period for repayment of principal, the currency, etc. The discount rate of such financial assets held to maturity is 10%.

(iii) It is not practicable to determine the fair values of financial assets carried at cost when these investments are not publicly traded. Refer to note 5 for details.

(Continued)

(iv) On December 31, 2013 and 2012, the discount rates used to estimate the fair value of refundable deposits were the average interest rates on time deposits of 0.752% and 1.30%, respectively.

(v) The interest rates on restricted deposits are substantially the market interest rates. Therefore, the amounts of the deposits are treated as the fair value.

(4) The details of quoted market prices and estimated fair values of financial instruments were as follows:

	December 31,			
	2013		2012	
	Quoted market price	Estimated fair value	Quoted market price	Estimated fair value
Financial assets:				
Cash	$ 2,865,656	-	2,129,924	-
Financial assets measured at fair value – current	14,570	-	9,634	-
Notes and accounts receivable (including related parties)	-	2,525,927	-	2,196,759
Other receivables – related parties	-	271,526	-	248,332
Other financial assets – current	-	62,183	-	34,834
Available-for-sale financial assets – current	-	-	71,857	-
Available-for-sale financial assets – non-current	175,617	-	133,825	-
Financial assets held to maturity	-	-	-	4,299
Refundable deposits	-	33,099	-	33,098
Restricted deposits	355,246	-	353,147	-
Financial liabilities:				
Short-term borrowings	-	29,942	-	-
Financial liabilities measured at fair value – current	-	29,107	-	5,653
Notes and accounts payable (including related parties)	-	1,219,664	-	894,890
Deposits received	-	3,051	-	2,969

(Continued)

(5) Financial risk information

(i) Market risk

The Company's purchases and sales are mainly denominated in foreign currency. As a result, current and future cash flows of foreign currency assets and liabilities are exposed to the risk of foreign currency exchange rate volatility. Therefore, the Company engaged in derivative financial instrument transactions as economic hedges against potential changes in assets or liabilities held in foreign currencies. Gains and losses arising from changes in exchange rates are offset by those of the hedged item. As a result, the market risk is low.

Beneficiary certificates and listed stock held by the Company are presented under financial assets measured at fair value or available-for-sale financial assets. Such assets are measured at fair value, and the Company is exposed to market price volatility.

(ii) Credit risk

The Company's potential credit risk is derived primarily from deposits with banks, financial assets measured at fair value – current, available-for-sale financial assets, and accounts receivable. The Company maintains its cash in various creditworthy financial institutions and purchases funds and stocks issued by companies with good credit ratings. Credit risk exposure to each financial institution is controlled by the Company. As a result, the Company believes that there is no concentration of credit risk of cash and financial assets.

The main customers of the Company are multinational companies or companies with good credit ratings. From time to time, the Company monitors customers' credit condition, and hence has not encountered any significant loss due to credit risk.

Although, there is a potential for concentration of credit risk, the Company continually assesses the collectability of accounts receivable and makes a corresponding allowance for doubtful accounts. The Company's management does not foresee any significant credit risk loss for the Company.

(iii) Liquidity risk

There is no liquidity risk of being unable to raise capital to settle contract obligations since the Company has sufficient capital and working capital to fulfill contract obligations. As there is no open market for the financial assets carried at cost, they are subject to liquidity risk.

(Continued)

(iv) Cash flow risk resulting from change in interest rates

The financial assets of the Company with cash flow risk resulting from a change in interest rates were $2,865,110 and $2,070,179 as of December 31, 2013 and 2012, respectively. The financial liabilities of the Company with cash flow risk resulting from a change in interest rates were $29,942 and $0 as of December 31, 2013 and 2012, respectively.

16. Related-parties Transactions

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

Name	Relationship
Unizyx Holding Corporation (Unizyx)	Parent company owning 100% of ZyXEL
MitraStar Technology Corporation (MitraStar)	100% owned by Unizyx
Wuxi Genezys Technology Ltd.	100% owned by MitraStar

(2) Significant transactions with related parties are summarized below:

(a) Sales

	2013		2012	
	Amount	Percentage of net sales	Amount	Percentage of net sales
MitraStar	$ 1,062	-	918	-

The selling prices of related-party transactions are based on market information. The terms of payment are 90 to 180 days after delivery. As of December 31, 2013 and 2012, all account receivables-related parties generated by the abovementioned transaction has been received.

(b) Purchases

	2013		2012	
	Amount	Percentage to net purchases	Amount	Percentage to net purchases
MitraStar	$ 5,360,808	72	6,853,383	79

(Continued)

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The terms of payment for purchases from a related party are 60 days after the purchase. The collection terms for purchases from third parties were 60 to 90 days. The accounts payable for purchases from the above related party were as follows:

		December 31, 2013	December 31, 2012
MitraStar	$	471,437	451,483

(c) ZyXEL paid consulting fees to Unizyx amounting to $70,038 and $73,299, and they were recorded as operating expenses for the years ended December 31, 2013 and 2012, respectively. As of December 31, 2013 and 2012, all other payables – related parties generated by the abovementioned transaction had been paid.

The Company had entrusted Wuxi Genezys Technology to perform R&D of products. The payment of $10,063 and $12,858 for the years ended December 31, 2013 and 2012, respectively, was determined by certain additions of actual expense and was recorded under operating expense. As of December 31, 2013 and 2012, all other payables – related parties generated by the abovementioned transaction had been paid.

(d) Advances

Uncleared mutual advances between related parties are recorded as other receivables (payables) – related parties. They were as follows:

		December 31, 2013	December 31, 2012
Other receivables – related parties			
MitraStar	$	1,930	654

(e) Endorsements

(I) The endorsements by the Company for related parties were as follows:

		2013		2012	
		Highest Balance	Ending Balance	Highest Balance	Ending Balance
MitraStar	$	-	-	2,400	-

(Continued)

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(II) The endorsements by related parties for the Company were as follows:

		2013		2012	
		Highest Balance	**Ending Balance**	**Highest Balance**	**Ending Balance**
By Unizyx for ZyXEL	$	-	-	350,000	-
By Unizyx for ZyXEL Communications (Shanghai) Corp.		-	-	60,560	58,080
	$	**-**	**-**	**410,560**	**58,080**

(f) Loans

The Company makes loans to its related parties and records them as other receivables – related parties. They were as follows:

		2013				2012			
Related Party		**Highest Balance**	**Ending Balance**	**Interest Rate Range**	**Interest Revenue**	**Highest Balance**	**Ending Balance**	**Interest Rate Range**	**Interest Revenue**
MitraStar	$	250,000	250,000	1%~ 2.89%	3,896	250,000	246,840	2.89%	235
Unizyx		-	-	-	-	200,000	-	-	-
	$	**250,000**	**250,000**		**3,896**	**450,000**	**246,840**		**235**

As of December 31, 2013 and 2012, the unpaid amounts were $662 and $0, and they were recorded as other receivables – related parties.

(g) Tax combination

Started from 2011, ZyXEL and its parent company, Unizyx, file their corporate income tax on a combination basis. The estimated receivables from Unizyx and MitraStar of tax combination were $18,934 and $838 as of December 31, 2013 and 2012, recorded as other receivables – related parties.

17. Pledged Assets

Assets pledged as collateral are summarized as follows:

Pledged assets	Pledged to secure		December 31, 2013	2012
Restricted deposits	1. Guarantees provided by bank for Armaments Bureau of Ministry of National Defense in the second phase 2. Warranty provided for Armaments Bureau of Ministry of National Defense in the second phase	$	330,858	325,553
Time deposit (recorded as restricted deposits)	Contract fulfillment and warranty guarantee		17,321	20,332
Restricted deposits	Rental contract for land, plant, and parking lot with the Science-Based Industrial Park Administration		7,067	7,067
Restricted deposits	Warranty fund for the project		-	195
		$	355,246	353,147

18. Commitments and Contingencies

(1) The Company entered into twenty-year renewable operating lease agreements for land and operating facilities with the Science-based Industrial Park Administration ("SIPA") which will expire on December 31, 2017, and December 31, 2025, with an annual rental subject to SIPA adjustments. In addition, certain subsidiaries leased their offices. Minimum payments in future years under current operating lease agreements are listed below:

Year		Amount
2014	$	67,755
2015 to 2019		141,405
2020 and thereafter		16,151
	$	225,311

As of December 31, 2013, the Company rented land from the SIPA, and the bank had issued a guarantee of $7,067.

(2) The Company signed technology licensing agreements with certain companies and was required to pay licensing fees in proportion to sales revenue of the licensed products under the agreements.

(3) The Company signed agency service agreements with certain companies and was required to pay commission fees in proportion to commissioned sales under the agreements.

(Continued)

(4) ZyXEL entered into purchase agreements for wireless electrical engineering for vehicles with the purchasing center of the Armaments Bureau, Ministry of National Defense (M.N.D.), and the purchases amounted to $6,689,580. ZyXEL authorized the bank to submit a performance bond with joint-liability guarantee amounting to $334,479 to the purchasing center of the Armaments Bureau equal to five percent of the purchase price. As of December 31, 2013 and 2012, the balance of the performance bond with joint-liability guarantee amounted to $0. In addition, ZyXEL should pay a technology transfer royalty equal to some percentage of the purchase price. The deposits that ZyXEL provided based on the warranty, purchase agreements, and the joint-liability guarantee for advance payments amounted to $323,182 and $325,553 as of December 31, 2013 and 2012, respectively.

(5) In 2008, Northpeak Wireless, L.L.C. (“Northpeak”) asserted that ZyXEL sold products that infringed certain Northpeak patents and brought suit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on current operations.

(6) In 2012, ReefEdge Network L.L.C. asserted that ZyXEL sold products that infringed certain patents of ReefEdge Network and brought suit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL reached a settlement with Reefedge Network L.L.C. in August 2013.

(7) In 2012, Gordium Innovations, L.L.C. asserted that ZyXEL sold products that infringed certain patents of Gordium Innovations, L.L.C. and brought suit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL reached a settlement with Gordium Innovations, L.L.C. in October 2013.

(8) In 2012, AIM IP L.L.C. asserted that ZyXEL sold products that infringed certain patents of AIM IP L.L.C. and brought suit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL reached a settlement with AIM IP L.L.C. in January 2013.

(9) In 2013, Norman IP Holdings, L.L.C. asserted that ZyXEL sold products that infringed certain patents of Norman IP Holdings, L.L.C. and filed a lawsuit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on its current operations.

(10) In 2013, Penovia L.L.C. asserted that ZyXEL sold products that infringed certain patents of Penovia L.L.C. and filed a lawsuit against ZyXEL’s subsidiary ZyXEL Communications Inc. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on its current operations.

(Continued)

(11) In 2013, Esprit Changeware asserted that ZyXEL infringed certain copyright of Esprit Changeware and filed a lawsuit against ZyXEL. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on its current operations.

(12) In 2013, TQDelta, L.L.C. asserted that ZyXEL sold products that infringed certain patents of TQDelta, L.L.C. and filed a lawsuit against ZyXEL's subsidiary ZyXEL Communications Inc. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on its current operations.

(13) In 2013, Innovative Wireless Solution, L.L.C. asserted that ZyXEL sold products that infringed certain patents of Innovative Wireless Solution, L.L.C. and filed a lawsuit against ZyXEL's subsidiary ZyXEL Communications Inc. ZyXEL is pursuing the lawsuit with a lawyer. However, ZyXEL believes that the abovementioned event will not have a significant effect on its current operations.

(14) As of December 31, 2013 and 2012, ZyXEL had outstanding letters of credit amounting to US$682 and US$0, respectively. The outstanding letters of credit facilitate ZyXEL's purchase of materials from suppliers.

(15) As of December 31, 2013 and 2012, the amounts of notes pledged at the bank for financing purposes were $1,178,803 and $1,632,320, respectively.

(16) As of December 31, 2013 and 2012, ZyXEL had asked a bank to submit a performance guarantee letter for a sales contracts of Telecom Argentina S.A. and Telefonica Chile S.A. The guarantees amounted to $20,050 and $0, respectively.

(17) In order to bid on the projects of Bank of Taiwan, Chunghwa Telecom Co., Ltd., and others, ZyXEL Communications Inc. asked a bank to submit a performance guarantee letter and warranty guarantee letter to the counterparties. The guarantees amounted to $15,549 and $13,898 as of December 31, 2013 and 2012, respectively.

(18) In order to bid on the projects, ZyTPE Communications Corporation asked a bank to submit a performance guarantee letter amounting to $36,816 and $36,249 as of December 31, 2013 and 2012, respectively.

(19) ZyXEL and MitraStar agreed to sign a Service-On-Demand Broadband Home Gateway and Cloud-based Application Platform contract with the Industrial Development Bureau of the Ministry of Economic Affairs that was valid from April 1, 2011, to September 30, 2012. The subsidy for the contract is $17,280 ($11,604 for ZyXEL and $5,676 for MitraStar). Furthermore, in order to obtain such grant fund, $7,960 and $17,280 were guaranteed by bank and ZyXEL's check, respectively, as of December 31, 2012. However, the grant funds guaranteed by the bank and ZyXEL's check were withdrawn in January 2013.

(Continued)

ZyXEL Communications Corp. and Subsidiaries

Notes to Consolidated Financial Statements

19. Other Information

(1) The Company's personnel, depreciation, and amortization expenses, by function, are summarized as follows:

Account	2013			2012		
	Cost of goods sold	Operating expenses	Total	Cost of goods sold	Operating expenses	Total
Personnel expenses:						
Salaries	$ 37,517	1,281,950	1,319,467	$ 41,068	1,063,381	1,104,449
Labor and health insurance	3,957	175,364	179,321	3,708	84,943	88,651
Pension	1,399	56,367	57,766	1,520	36,045	37,565
Others	2,618	66,991	69,609	2,217	58,892	61,109
Depreciation	2,394	65,586	67,980	5,977	58,494	64,471
Amortization	-	15,285	15,285	-	29,867	29,867

(2) The significant financial assets and liabilities in foreign currency were as follows (in thousands):

	December 31,					
	2013			2012		
	Foreign currency	Exchange rate	NTD	Foreign currency	Exchange rate	NTD
Financial assets						
Monetary Items						
US Dollar	27,025	29.805	805,480	34,306	29.04	996,246
EURO	3,022	41.09	124,174	3,305	38.49	127,209
Financial liabilities						
Monetary Items						
US Dollar	21,187	29.805	631,479	11,779	29.04	342,062