

# SECURITIES AND EXCHANGE COMMISSION

## FORM 10-K

Annual report pursuant to section 13 and 15(d)

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### FILER

#### **S3 INC**

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 UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION  
 WASHINGTON, D.C. 20549  
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FORM 10-K  
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(MARK ONE)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE  
 SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 1998

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE  
 SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO .

COMMISSION FILE NUMBER 0-21126

S3 INCORPORATED  
 (EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

<TABLE>

<S>	DELAWARE	<C>	77-0204341
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)		(I.R.S. EMPLOYER IDENTIFICATION NO.)	

2841 MISSION COLLEGE BOULEVARD	95054
SANTA CLARA, CALIFORNIA	(ZIP CODE)

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

</TABLE>

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (408) 588-8000  
 SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE  
 SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:  
 COMMON STOCK, \$.0001 PAR VALUE

SERIES A PARTICIPATING PREFERRED STOCK PURCHASE RIGHTS

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference to Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of voting stock held by non-affiliates of the Registrant was approximately \$420,458,976 as of March 1, 1999, based upon the closing price on the Nasdaq National Market reported for such date. This calculation does not reflect a determination that certain persons are affiliates of the Registrant for any other purpose.

51,848,023 shares of the Registrant's Common stock, \$.0001 par value, were outstanding at March 1, 1999.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10 (as to directors), 11 and 12 of Part III incorporate by reference information from the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Registrant's 1999 Annual Meeting of Stockholders.

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S3 INCORPORATED  
FORM 10-K

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## PART I

## ITEM 1. BUSINESS.

When used in this Report, the words "expects", "anticipates", "estimates" and similar expressions are intended to identify forward-looking statements. Such statements, which include statements concerning the timing of availability and functionality of products under development, trends in the personal computer ("PC") market, the percentage of export sales and sales to strategic customers, and the adoption or retention of industry standards, and the availability and cost of products from the Company's suppliers, are subject to risks and uncertainties, including those set forth under "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors That May Affect Our Results" and elsewhere in this report, that could cause actual results to differ materially from those projected. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

## GENERAL

S3(R) Incorporated ("S3" or the "Company") is a leading supplier of multimedia acceleration hardware and its associated software for the PC market. The Company's accelerators are designed to work cooperatively with a PC's central processing unit ("CPU"), implementing functions best suited for a

dedicated accelerator while allowing the CPU to perform the more general purpose computing functions of today's advanced multimedia user interface and applications. By complementing the computing power of the general purpose CPU, the Company's integrated software and silicon-based accelerator solutions significantly improve the multimedia performance of PCs while reducing overall system cost and complexity. S3 has been a pioneer in graphics acceleration since 1991, when it was the first company to ship in volume a single chip graphics accelerator with a local bus interface. S3 has since delivered new generations of high performance accelerator solutions from the first 32-bit and 64-bit graphics accelerator families to the first 128-bit, full-featured integrated two-dimensional ("2D") and three-dimensional ("3D") graphics and video accelerator specifically designed for today's 3D and digital versatile disc ("DVD")-based applications. As the demand for greater multimedia capabilities in PCs increases, particularly the demand for 2D/3D technology, the Company is focused on delivering accelerator solutions for use in business desktop, home and mobile computing systems. S3's families of accelerator products and software are currently used by many of the world's leading original equipment PC manufacturers ("OEMs") and add-in card and motherboard manufacturers.

S3 was incorporated on January 9, 1989 in the State of Delaware. The Company operates in one principal industry segment.

#### MARKETS AND RECENT DEVELOPMENTS

S3 supplies integrated 2D, 3D and video accelerators for the desktop and mobile markets. The desktop market is the largest segment of the PC industry for the Company's accelerator products and is characterized by intense competition and rapid technological advances. In 1998, S3 introduced the Savage3D accelerator. With the Savage3D chip, the Company redesigned its 3D architecture to deliver high-performance multimedia graphics, utilizing S3 texture compression ("S3TC") and single-pass trilinear filtering technologies. S3TC(TM) is a compression technology that compresses data up to one-sixth the normally required space, which allows for cost effectiveness, and was selected by Microsoft Corporation ("Microsoft") as the standard compression technique in DirectX(TM). The compression technique is also able to deliver photo-realistic 3D quality for the first time on the PC. Rapidly gaining industry support, S3TC has been widely adopted for use in 1999's top 3D software game titles, including Unreal and Unreal Tournament, Quake3 Arena, Half Life, Anachronox, Expendable and TrueSpace4 and is being incorporated in future software titles.(1) Combined with

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1The software titles set forth above may be trademarks or registered trademarks of their respective owners.

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S3TC, the single-pass trilinear filtering enhances image quality over traditional bilinear filtering and enables high 3D graphics performance by removing motion artifacts for smoother images without performance degradation.

The Company entered into the mobile market with the introduction of the Aurora64V+ product. The Company's mobile strategy is to combine the same level of 2D, 3D and video capabilities found in S3's desktop accelerators with advanced power management and flat panel display support. S3's second-generation mobile product, the ViRGE/MX accelerator, brings powerful capabilities to notebook PC users that exceeds the performance and functionality levels of core feature available for the mobile PC platform by providing industry-first technologies such as fully-integrated TV-out, DuoView dual display capability and AGP support.

In December 1998, S3 announced a long-term strategic relationship with Intel Corporation ("Intel"). The agreements with Intel include a 10-year cross-license agreement for all S3 and Intel patents for the development of certain semiconductor products, a bus license for current and future Intel general purpose processors, and the selection of S3 as an Intel Accelerated Graphics Port ("AGP") 4X validation partner. S3 had previously acquired certain patents and patent applications from Cirrus Logic Inc. to which Intel already had a license. The graphics industry is transitioning from 2X AGP to 4X AGP and the Company intends to take advantage of this opportunity to create a differentiating advantage in graphics as well as to create major opportunities outside the traditional desktop and mobile space. To do this, the Company intends to pursue an integration strategy that involves both integrating core logic and graphics.

In February 1999, S3 introduced the second generation of the Savage family. The Savage4 accelerator features industry-first 4X AGP, S3TC and advanced

digital flat panel display support.

## PRODUCTS

S3's product strategy is to offer an integrated 2D/3D multimedia solution comprised of hardware and software designed around a common architecture that will become the standard graphics engine and a cost-effective package for the desktop and mobile markets. The Company has developed a series of advanced graphics and video accelerators for use by mainstream multimedia computer suppliers in high performance, cost effective products for the business, home and mobile markets. All of S3's accelerator solutions are designed to complement the CPU by executing those functions most appropriate to a dedicated accelerator while allowing the CPU to execute the more general purpose computing functions. The Company's graphics and video accelerator product line includes a broad array of products to support PC add-in card, motherboard and computer system OEM designs in both desktop and mobile markets. S3's family of products range from accelerators designed for the desktop market that target cost-conscious consumers to fully-featured multimedia systems designed for high-end mobile and desktop markets. The Company works closely with its key customers in each of those areas to design the products that meet the needs of the individual markets.

### GRAPHICS AND VIDEO ACCELERATOR PRODUCTS

ViRGE/MX. ViRGE/MX is the second generation 3D graphics accelerator for notebook PCs, which combines the same level of 2D/3D video acceleration found in the Company's desktop accelerators with advanced power management and flat panel display support. The product features DuoView, integrated TV-out and a full set of 3D rendering, including MIP mapping, tri-linear filtering and perspective correction textures. The product also supports the AGP standard.

Trio3D. Trio3D is the third generation of the Trio family of accelerators. It features a 128-bit pipeline architecture, support for 125 MHz SGRAM memory and S3's Burst Command Interface(TM) -- a proprietary protocol technology that works in conjunction with either the PCI or AGP bus to increase the command and data efficiency of the Trio3D architecture. Trio3D also supports 3D rendering and is the first accelerator to fully implement the industry standard Video Interface Port ("VIP") bus which provides a dedicated interface from the graphics accelerator to digital video devices and streamlines the movement of this data versus current PCI bus solutions. The Trio3D allows for a low-cost, easy-to-implement interface to third party multimedia peripherals such as video cameras, TV-tuners and DVD/MPEG-2 decoders. It also provides support for AGP standard and is designed to be pin-compatible with existing Trio and ViRGE-based designs. In addition,

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Trio3D's software compatibility with previous generations of S3 products is intended to enable faster time-to-market for manufacturers.

Savage3D. Savage3D is the first generation of a newly designed multimedia solution for 2D, 3D and DVD/video acceleration. It features a 128-bit single cycle trilinear architecture, support for 4X AGP and Microsoft-endorsed texture compression technology. The single trilinear filtering enables the high 3D graphics performance. Savage3D is the first 3D accelerator to utilize S3TC, a Microsoft-endorsed texture compression technology. Savage3D produces images through its true color rendering, which enables the use of 16 million colors and is optimized for full 2X AGP. Savage3D is pin-compatible with the Trio3D.

Savage4. Savage4 is the second generation of the Savage family of accelerators. Designed for the consumer and commercial PC markets, S3's Savage4 delivers 2D graphics and video acceleration, as well as 3D rendering capabilities equivalent to high-end, niche gaming solutions. Savage4 features a 128-bit 3D engine, AGP 4X technology, true 32-bit 3D rendering, S3TC, trilinear filtered single-pass multi-texturing, hardware accelerated DVD, 32 MB memory support and complete digital flat panel support. Currently, Savage4 comes in two configurations: the Savage4 PRO and the Savage4 GT. The Savage4 PRO incorporates industry-first AGP 4X technology, 143MHz memory support and up to a 32MB local frame buffer, while the Savage4 GT incorporates AGP 2X technology, 125MHz memory support and up to a 16MB local frame buffer for low-end PC markets.

### SOFTWARE

The Company believes that a complete solution for its customers must include not only high performance acceleration features implemented in silicon, but also a broad line of software, including BIOS, drivers and utilities, that are designed to optimize the performance of its accelerators. The software is shipped as an integral part of the Company's accelerator products. The Company

maintains a flexible driver architecture, allowing its drivers to be easily upgraded for the enhanced features supported in next generation accelerator products. S3 uses a combination of in-house software developers and independent contractors to develop its software drivers. The Company's in-house software development team develops strategic software, including BIOS and drivers for the Windows family of operating systems. The Company believes that software expertise is vital to determining the optimal trade-off between silicon and software for next generation accelerator performance and functionality enhancements. The Company has also developed extensive capabilities for testing its accelerators, software drivers and BIOS across a range of applications and OEM system configurations.

S3 is also actively developing software drivers for what have emerged as the standard APIs for 3D acceleration. Microsoft's Direct3D has emerged as the standard API for the mainstream PC platform and Silicon Graphics, Inc.'s ("Silicon Graphics") OpenGL emerged as the standard API for high-performance 3D graphics. S3 intends to support its proprietary API, OpenGL, Direct3D and third-party APIs based on market acceptance of such APIs and S3's needs to support and promote new features of future accelerators. S3 has developed an OpenGL driver for the ViRGE, Trio and Savage family of 2D/3D accelerators to support CAD/engineering, modeling/rendering and other high-end 3D applications traditionally supported on workstation platforms. In August 1997, the Company and Silicon Graphics announced a long term licensing agreement whereby S3 will distribute OpenGL. The Company will provide its OEM customers with source and object code for OpenGL, a proven, highly versatile 2D and 3D graphics API that enables PC, workstation and supercomputing hardware vendors to provide high-performance graphics solutions.

#### FUTURE ACCELERATORS AND SOFTWARE

The Company has in development several graphics and video accelerators and related software products for currently scheduled introduction throughout 1999. S3 believes that its extensive software, systems and silicon expertise, use of advanced design tools, centralized engineering group with strong design expertise and close working relationships with strategic customers and software developers should position the Company to continue to rapidly and cost-effectively define, develop and market advanced accelerators and related software for the PC market. The Company analyzes and uses industry tools such as Ziff Davis 3-D benchmark, 3-D

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Winbench 98 and other independent benchmarking software in its efforts to provide the highest level of accelerator and feature compliance. In future products, the Company plans to be fully compliant with the graphics initiative from Intel for AGP as defined by the PC98 and PC99 system design guides, which are a reference for designing PCs and peripherals for the Microsoft Windows family of operating systems and are primarily driven by Microsoft, Intel and other industry leaders.

Recognizing the rapid conversion of consumer electronic products from analog to digital technology, the convergence of consumer and computing systems into new and evolving information access devices and the personal computer's inherent position as the most advanced and well-positioned digital platform, the Company intends to leverage its PC system architecture and multimedia acceleration expertise to develop new products for both computer and consumer applications that exploit these trends.

#### SALES, MARKETING AND DISTRIBUTION

S3 markets and distributes its products through a direct sales organization supported by field applications engineers, as well as through a network of independent manufacturers' representatives and regional distributors. In North America, the Company uses a combination of independent manufacturers' representatives and a direct sales force operating from the Company's sales offices in California, Georgia, North Carolina and Texas. In Asia, the Company operates from sales and distribution offices in Hong Kong, Japan, Singapore and Taiwan, and through manufacturers' representatives and local distributors located in Hong Kong, Japan, Korea and Taiwan. In Europe, the Company uses organizations that are both manufacturers' representatives and distributors in France, Germany and the United Kingdom. The loss of one or more representatives could have an adverse effect on the Company's operating results. The Company has a global shipment program pursuant to which certain finished products are shipped directly to customers from the Company's independent assembly and testing houses. This program is intended to provide more timely delivery of such products to those customers by eliminating the intermediate step of shipping finished products to the Company's Santa Clara, California facility for

repackaging and reshipment.

The Company sells multimedia accelerators to original equipment manufacturers, third party subsystem manufacturers, motherboard manufacturers and distributors. Sales to these customers are typically made pursuant to specific purchase orders, which are cancelable without significant penalties. In 1998, three customers, Synnex Technology, Inc. ("Synnex"), IBM Corporation and Promate Electronics Co., accounted for 39%, 14% and 13%, respectively, of net sales. In 1997, three customers, Synnex, CNW International Limited, and Compaq Computer Corporation, accounted for 20%, 13% and 12%, respectively, of net sales. In 1996, two customers, Diamond Multimedia Systems, Inc., and Synnex, accounted for 16% and 15%, respectively, of net sales. Synnex, CNW International Limited and Promate Electronics Co. are distributors. The Company expects a significant portion of its future sales to remain concentrated within a limited number of strategic customers. There can be no assurance that the Company will be able to retain its strategic customers or that such customers will not otherwise cancel or reschedule orders, or in the event of canceled orders, that such orders will be replaced by other sales. In addition, sales to any particular customer may fluctuate significantly from quarter to quarter. The occurrence of any such event could have a material adverse effect on the Company's operating results. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors That May Affect Our Results -- We Have Significant Exposure to International Markets."

Export sales accounted for 89%, 70% and 58%, of net sales in 1998, 1997 and 1996 respectively. Approximately 29% of export sales in 1998 were to affiliates of United States customers. Due to its export sales, the Company is subject to the risks of conducting business internationally, including those set forth under "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors That May Affect Our Results -- We Have Significant Exposure to International Markets."

#### CUSTOMER SUPPORT AND SERVICE

The Company believes that customer service and technical support are important competitive factors in the accelerator market. The Company provides technical support for customers in major markets in North

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America, Europe and Asia. Distributors and manufacturers' representatives supplement the Company's efforts by providing additional customer service and technical support for the Company's products. The Company also provides several other types of technical support, including software distribution through the World Wide Web, product demonstration software, evaluation boards and application notes.

The Company works closely with its customers in tracking the progress of its product designs, providing applications design support and upgrading the customers' software to provide the latest enhancements. The Company believes that close contact with its customers not only improves their level of satisfaction, but also provides important insights into defining the system requirements for next generation accelerators and related software products.

#### MANUFACTURING AND DESIGN METHODOLOGY

The Company currently relies on two independent foundries to manufacture all of its products. The Company's strategy is to utilize a number of qualified foundries that it believes provide cost, technology or capacity advantages for specific products. This "fabless" strategy allows the Company to avoid the significant capital investment to construct an in-house wafer fabrication facility and is a well entrenched business model within the semiconductor industry. As a result, the Company is able to focus its resources on product design and development, quality assurance, marketing and customer support. The Company's accelerators are currently manufactured using a five level metal complementary metal oxide semiconductor ("CMOS") process with line geometries as small as 0.25 micron. The Company will utilize a six level metal CMOS process with 0.18 micron line geometries for certain of its products scheduled for 1999 production. In order to provide increased functionality to meet the needs of the multimedia market without substantially increasing die size, the Company's products will have to be manufactured using increasingly smaller line geometries. The Company designs its products using proprietary circuit modules that are scalable in size to enable more rapid adoption of smaller line geometry manufacturing processes and a common design rule approach to operate within the process parameters of multiple foundries. Multiple sources for certain products increase the Company's ability to supply its customers with those products and reduce the Company's dependence on any single foundry. However, the Company has

not developed alternate sources of supply for certain products, and its newly introduced products are typically produced initially by a single foundry until alternate sources can be qualified. The Company currently has long-term manufacturing capacity arrangements with two suppliers as described below. The Company conducts business with one of its current foundry suppliers by delivering written purchase orders specifying the particular product ordered, quantity, price, delivery date and shipping terms and, therefore, this foundry is not obligated to supply products to the Company for any specific period, in any specific quantity or at any specified price, except as may be provided in a particular purchase order. To the extent a foundry terminates its relationship with the Company or should the Company's supply from a foundry be interrupted or terminated for any other reason, such as a natural disaster, the Company may not have a sufficient amount of time to replace the supply of products manufactured by that foundry.

Historically, certain subcontract suppliers have also provided packaging and testing for the Company's products and other activities necessary to deliver finished products. The Company pays those suppliers for assembled or fully tested products meeting predetermined specifications. In the assembly process, the silicon wafers are separated into individual die after wafer level testing that are then assembled into packages and tested in accordance with the Company's test procedures. Following assembly, the packaged devices are further tested and inspected pursuant to the Company's quality assurance program before shipment to customers. Due to increasing complexity and high pin counts required by the Company's products, the Company is increasing its use of Ball Grid Array ("BGA") packaging. This package technology is now widely sourced in the industry and the Company presently has three sources of supply qualified and in production. To ensure the integrity of its foundries' quality assurance procedures, the Company develops detailed test procedures and specifications for each product and requires the foundry to use those procedures and specifications before shipping finished products or wafers. Product returns to date have not been significant.

In 1995, the Company entered into two long-term manufacturing capacity arrangements. The Company entered into an agreement with United Microelectronics Co., Ltd. ("UMC") and Alliance Semiconductor Corporation to form United Semiconductor Corporation ("USC"), a separate Taiwanese company, for the

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purpose of building and managing a semiconductor manufacturing facility in the Science-Based Industrial Park in Hsin Chu City, Taiwan. The facility began production utilizing advanced submicron semiconductor manufacturing processes in 1996. The Company has the right to purchase 31.25% of the output from the foundry. See Note 3 of Notes to Consolidated Financial Statements for a description of the sale of a portion of the Company's investment in USC. In addition, the Company expanded and formalized its relationship with Taiwan Semiconductor Manufacturing Company ("TSMC") to provide additional capacity over the 1996 to 2000 timeframe. The agreement with TSMC requires the Company to make certain annual advance payments to be applied against the following year's capacity. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

There can be no assurance that the Company will obtain sufficient sources of supply of product to meet customer demand in the future. Obtaining sufficient foundry capacity is particularly difficult during periods of high growth, and may become substantially more difficult if the Company's product requirements increase significantly. In addition, because the Company must order products and build inventory substantially in advance of product shipments, there is a risk that the Company will forecast incorrectly and produce excess or insufficient inventories of particular products. This inventory risk is heightened because certain of the Company's key customers place orders with short lead times. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Factors That May Affect Our Results -- We are a Fabless Semiconductor Company and Depend on Independent Foundries for the Manufacture of Our Products."

PC graphics and multimedia subsystems include, in addition to the Company's products, a number of other components, which are supplied by third party manufacturers. Any shortage of such components in the future could adversely affect the Company's business and operating results.

The Company uses an automated design environment based on advanced workstations, dedicated product simulators, system simulation with hardware and software modeling, and the use of a high level design description language in order to more rapidly define, develop and deliver new and enhanced products. The Company considers its computer-aided engineering ("CAE") and computer-aided design ("CAD") capabilities to be important to its future success in all areas

of new product development and intends to continue to enhance its CAE/CAD systems. Although the Company extensively tests its software and hardware products prior to their introduction, it is possible that design errors may be discovered after initial product sampling, resulting in delays in volume production or recall of products sold. The occurrence of any such errors could have a material adverse effect on the Company's product introduction schedule and operating results.

#### RESEARCH AND DEVELOPMENT

The Company believes that continued timely development and introduction of new products are essential to maintaining its competitive position. The Company currently conducts most of its product development effort in-house and, at December 31, 1998, had a staff of 276 research and development personnel, of whom approximately 34% are involved in software development. The Company also employs outside consultants to assist with software testing. The Company is focusing its current development efforts primarily on the development of enhanced versions of its existing family of graphics and multimedia accelerators and adding new functionality to its products for business desktop, mobile and home PC markets. In addition, the Company intends to continue to devote significant resources to the development of a broad range of high-performance software drivers to support its products. During 1998, 1997 and 1996, the Company spent approximately \$78.6 million, \$78.6 million and \$63.4 million, respectively, on research and development activities.

#### COMPETITION

The markets in which the Company competes are extremely competitive and the Company expects that competition will increase. The principal factors of competition in the Company's markets include performance, product features, product availability, price, quality, timing of new product introductions by the Company and its competitors, the emergence of new graphics and PC standards and customer support. Price competition in the industry is intense and may increase, which may have a material adverse effect on the

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Company's operating results. There can be no assurance that the Company will be able to compete successfully as to price or any of these other factors.

The market for the Company's products is extremely competitive and is characterized by declining selling prices over the life of a particular product and rapid technological changes. The Company's principal competitors for graphics accelerators include 3DFX Interactive Inc., ATI Technologies, Inc., Intel Corporation, Matrox Graphics Inc., NVIDIA Corporation and Trident Microsystems, Inc. The Company's principal competitors in the multimedia market include the companies named in the preceding sentence and a number of smaller companies which may have greater flexibility to address specific market needs. Potential competitors in these markets include both large and emerging domestic and foreign semiconductor companies. In particular, there is a significant number of established and emerging companies that have developed, are developing or have announced plans to develop 3D graphics chips. There can be no assurance that the Company's product offerings to address the demand for the next generation of 2D/3D accelerators will be competitive, and if such product offerings are not competitive, the Company's results of operations in 1999 and future periods could be materially and adversely affected. The Company's current products do not address the high performance segment of the market, which has resulted in substantial pricing and margin pressures on the Company's products and adversely affected the Company's recent results of operations. The entry of additional competitors into the 2D/3D accelerator market has resulted in and is expected to continue to result in pricing pressures on average selling prices of the Company's products. To the extent the Company expands its product line to add products with additional functionality, it will encounter substantial competition from established semiconductor companies and may experience competition from companies designing chips based on different technologies. Furthermore, the need of PC manufacturers to rapidly introduce a variety of products aimed at different segments of the PC market may lead to the shift by such system OEMs to the purchase of graphics and multimedia add-in cards provided by others. Certain of the Company's competitors supply both add-in cards and accelerator chips, which may provide those competitors with an advantage over suppliers such as the companies that supply only accelerator chips. In addition, certain of the Company's potential competitors that supply add-in cards and/or motherboards, such as Intel, may seek to use their card/board business to leverage the startup of their graphics accelerator business. Certain of the Company's current and potential competitors have greater technical, manufacturing, financial and marketing resources than the Company. The Company believes that its ability to compete successfully depends

upon a number of factors both within and outside of its control, including product performance, product features, product availability, price, quality, timing of new product introductions by the Company and its competitors, the emergence of new graphics and PC standards, customer support and industry and general economic trends. There can be no assurance that the Company will have the financial resources, technical expertise or marketing, distribution and support capabilities to compete successfully. The Company's future success will be highly dependent upon the successful development and introduction of new products that are responsive to market needs. There can be no assurance that the Company will be able to successfully develop or market any such products.

#### LICENSES, PATENTS AND TRADEMARKS

The Company has filed several United States patent applications for its technology and to date has been issued 16 United States patents. The Company has also built its patent portfolio substantially through acquisitions. In 1997, the Company acquired certain microprocessor patents from Exponential Technology Inc. In January 1998, the Company entered into a patent purchase and cross-licensing agreement with Cirrus Logic, Inc. pursuant to which the Company purchased 10 graphics patents and 25 graphics patent applications and cross-licensed other graphics-related technology. Since the purchase date, 11 of these patent applications have become issued patents. The Company attempts to protect its trade secrets and other proprietary information through agreements with its customers, suppliers, employees and consultants, and through other security measures. Although the Company intends to protect its rights vigorously, there can be no assurance that these measures will be successful or that any issued patents will provide the Company with adequate protection with respect to the covered products, technology or processes.

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The Company has applied to the United States Patent and Trademark Office for registration of a number of trademarks and also holds common law rights in a number of trademarks. A U.S. trademark registration has been issued to the Company for the marks S3, S3 (stylized), S3 ON BOARD, S3 ON BOARD and Design, S3D(stylized), Trio, True Acceleration and ViRGE.

The S3 corporate logo, the Aurora family of marks, Cooperative Accelerator Architecture, Burst Command Interface, DuoView, InfiniPatch, InfiniRate, Innovations In Acceleration, No Compromise Acceleration, No Compromise Integration, QuickRamp, RIO!, S3FM, S3RAM, S3S, SAVAGE3D, SAVAGE4, Scenic Highway, Sight. Sound. Speed., Silicon Film, SmartFilter, Streams Processor, the Trio family of marks, TV-Tuner and the ViRGE family of marks are trademarks of the Company. The Company has also applied for trademark registration of some of its trademarks in certain foreign jurisdictions. There can be no assurance that the Company will obtain the registrations for which it has applied. Other trademarks referenced in this document are owned by their respective companies.

If the Company's use of a registered or unregistered trademark were found to violate a third party's common law or statutory trademark rights, the Company's business could be adversely affected. In addition, the laws of certain countries in which the Company's products are or may be developed, manufactured or sold, including Hong Kong, Japan and Taiwan, may not protect the Company's products and intellectual property rights to the same extent as the laws of the United States.

#### BACKLOG

Sales of the Company's products are made pursuant to standard purchase orders that are cancelable without significant penalties. In addition, purchase orders are subject to price renegotiations and to changes in quantities of products and delivery schedules in order to reflect changes in customers' requirements and manufacturing availability. The Company's business, and to a large and growing extent that of the entire semiconductor industry, is characterized by short lead time orders and quick delivery schedules. In addition, the Company's actual shipments depend on the manufacturing capacity of the Company's suppliers and the availability of products from such suppliers. As a result of the foregoing factors, the Company does not believe that backlog at any given time is a meaningful indicator of future sales.

#### EMPLOYEES

At December 31, 1998, the Company employed 434 individuals, of whom 34 were employed in operations, 276 in research and development, 61 in sales, marketing and technical support and 63 in administration and other support functions. Competition for personnel in the semiconductor, software and the PC industry in general is intense. The Company believes that its future success will depend, in

part, on its ability to continue to attract, train, motivate, retain and manage highly skilled technical, marketing and management personnel. None of the Company's employees is represented by a labor union or is subject to a collective bargaining agreement. The Company believes that its relations with its employees are good.

#### ITEM 2. PROPERTIES.

In December 1995, the Company entered into a limited partnership arrangement with a developer to obtain a ground lease and develop and operate the Company's future Santa Clara facilities. In January 1997, the Company relocated its principal administrative, sales, marketing, research and development facility consisting of approximately 300,000 square feet of space in two buildings located in Santa Clara, California, the initial phase of the development. This space is leased for an initial 12-year term. In October 1998, the Company sublet one of the buildings for the remaining term of the lease. The Company had an option, which expired in January 1999, to build an additional two buildings comprising approximately 300,000 square feet. In January 1999, the Company entered into a demand for arbitration related to the option. The demand for arbitration arose out of the disputed exercise date of the option. The Company believes that it exercised the option in December 1998 and the developer believes that the Company's option was not exercised.

The Company has vacated its previous Santa Clara facilities prior to the expiration of their lease terms in order to occupy the new facilities. The previous facilities consisted of approximately 159,000 square feet in

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four buildings in Santa Clara, California. The Company has sublet two of the buildings and terminated the leases on the remaining two buildings. The Company also leases office space in Texas, Hong Kong, Japan, Taiwan and a warehouse in Singapore in order to provide sales, distribution and technical support to customers in the United States and Asia. The facilities leased are currently sufficient for the Company's operations.

In connection with the Company's investment in the real estate partnership, in February 1997 the real estate partnership obtained permanent nonrecourse financing for the construction of the Santa Clara facilities. The Company is not a guarantor on the permanent financing.

#### ITEM 3. LEGAL PROCEEDINGS.

Since November 1997, a number of complaints have been filed in federal and state courts seeking an unspecified amount of damages on behalf of an alleged class of persons who purchased shares of the Company's common stock at various times between April 18, 1996 and November 3, 1997. The complaints name as defendants the Company, certain of its officers and former officers and certain directors of the Company, asserting that they violated federal and state securities laws by misrepresenting and failing to disclose certain information about the Company's business. In addition, certain stockholders have filed derivative actions in the state courts of California and Delaware seeking recovery on behalf of the Company, alleging, among other things, breach of fiduciary duties by such individual defendants. The derivative cases in California state court have been consolidated, and plaintiffs have filed a consolidated amended complaint. The court has entered a stipulated order in those derivative cases suspending court proceedings and coordinating discovery in them with discovery in the class actions in California state courts. On plaintiffs' motion, the federal court has dismissed the federal class actions without prejudice. The class actions in California state court have been consolidated, and plaintiffs have filed a consolidated amended complaint. The Company has answered that complaint. Discovery is pending. While management intends to defend the actions against the Company vigorously, there can be no assurance that an adverse result or settlement with regards to these lawsuits would not have a material adverse effect on the Company's financial condition or results of operations.

The Company has received from the United States Securities and Exchange Commission a request for information relating to the Company's restatement announcement in November 1997. The Company has responded and intends to continue to respond to such requests.

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. The Company is party to various claims of this nature. Although the ultimate outcome of these matters is not presently determinable, management believes that the resolution of all such pending matters will not have a material adverse effect on the Company's financial position or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Not applicable.

EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers of the Company and their ages as of March 31, 1999 are as follows:

<TABLE>

<CAPTION>

NAME	AGE	
----	---	
<S>	<C>	<C>
Kenneth F. Potashner	41	President and Chief Executive Officer, Chairman of the Board
Walter D. Amaral	47	Sr. Vice President Finance, Chief Financial Officer
Daniel A. Karr	39	Vice President of Sales
Paul G. Franklin	55	Sr. Vice President of Operations

</TABLE>

Mr. Kenneth F. Potashner joined the Company as Chairman of the Board, Chief Executive Officer and President of the Company in November 1998. From April 1996 to November 1998, Mr. Potashner served as President, Chief Executive Officer and Chairman of Maxwell Technologies, Inc., an electronics computer company. Mr. Potashner served as Executive Vice President, Operations and General Manager of the Disk

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Driver Operations at Conner Peripherals, Inc. from 1994 to 1996. Prior to 1994, Mr. Potashner held various management positions at Quantum Corporation, Digital Equipment Corporation and Texas Instruments Incorporated. Mr. Potashner holds a B.S.E.E. from Lafayette College and an M.S.E.E. from Southern Methodist University. Mr. Potashner is also a member of the Board of Directors of Maxwell Technologies, Inc., Newport Corporation and High Technology Solutions.

Mr. Amaral, Senior Vice President and Chief Financial Officer, joined the Company in August 1997. From April 1995 to August 1997, Mr. Amaral served as Senior Vice President, Finance and Chief Financial Officer of NetManage Incorporated, a supplier of networking software. From April 1992 to April 1995, Mr. Amaral was Senior Vice President and Chief Financial Officer of Maxtor Corporation, a disk drive manufacturer. From 1977 to 1992, Mr. Amaral held numerous positions at Intel Corporation, where he was most recently Corporate Controller. Mr. Amaral holds a B.S. in Business with a concentration in Accounting from San Jose State University.

Mr. Karr, Vice President of Sales, joined the Company in April 1996. From January 1988 to April 1996, Mr. Karr held various positions at Cirrus Logic, Inc., a manufacturer of integrated circuits, where he was most recently Sales Director. From May 1985 to January 1988, Mr. Karr held marketing and technical support positions at Adaptec, Inc., a supplier of bandwidth management solutions, where he was most recently Product Manager. Mr. Karr earned a B.A. in Physics and Mathematics from Linfield College.

Mr. Franklin, Senior Vice President of Operations, joined the Company in September 1992. From March 1991 to September 1992 he was a consultant to the Company. Mr. Franklin was a consultant for a number of semiconductor companies from January 1990 through March 1991. From March 1986 to December 1989, Mr. Franklin was Vice President of Operations of Actel Corporation, a supplier of field programmable gate arrays. Prior to 1986 Mr. Franklin held various management positions at Monolithic Memories Inc., a supplier of semiconductor memories and programmable logic.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The Company's common stock is traded on the Nasdaq National Market under the symbol "SIII". See "Selected Quarterly Consolidated Financial Data (Unaudited)" in "Item 8. -- Financial Statements and Supplementary Data" for the range of high and low closing sales prices for the common stock on the Nasdaq National Market, as reported by Nasdaq.

In December 1998, the Company entered into an agreement pursuant to which

it agreed to issue to Intel Corporation a warrant to purchase 1,000,000 shares of the Company's Common Stock at an exercise price of \$9.00 per share. The purchase price for the warrant was \$990,000. The warrant expires in December 2000. The Company relied upon the exemption provided by Section 4(2) of the Securities Act of 1933, as amended (the "Act"), because the transaction did not involve a public offering and the purchaser represented that it was an "accredited investor" as such term is defined in rules of the SEC promulgated under the Act.

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA.

<TABLE>  
<CAPTION>

	YEARS ENDED DECEMBER 31,				
	1998	1997	1996	1995	1994
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS AND RATIOS)				
<S>	<C>	<C>	<C>	<C>	<C>
STATEMENT OF INCOME DATA					
Net sales.....	\$ 224,639	\$ 436,359	\$ 439,243	\$ 316,309	\$ 140,309
Gross margin (loss).....	(2,072)	135,174	168,876	126,542	42,334
Research and development expenses.....	78,566	78,612	63,382	42,080	17,913
Selling, marketing and administrative expenses.....	41,926	55,879	48,800	33,510	18,310
Other operating expense(1).....	41,335	17,180	--	--	--
Income (loss) from operations.....	(163,899)	(16,497)	56,694	50,952	6,111
Net income (loss).....	\$(113,204)	\$ 8,878	\$ 41,588	\$ 35,374	\$ 5,502
Net income per share					
Basic.....	\$ (2.22)	\$ 0.18	\$ 0.88	\$ 0.83	\$ 0.15
Diluted(2).....	\$ (2.22)	\$ 0.17	\$ 0.81	\$ 0.75	\$ 0.14
Shares used in computing per share amounts:					
Basic.....	51,078	49,519	47,460	42,691	36,032
Diluted(2).....	51,078	51,740	52,451	47,013	39,621
Ratio of earnings to fixed charges(3).....	--	--	23.68x	--	165.98x
BALANCE SHEET DATA					
Cash and equivalents.....	\$ 31,022	\$ 90,484	\$ 94,616	\$ 69,289	\$ 25,772
Short-term investments.....	88,553	27,186	62,768	24,630	8,800
Working capital.....	152,244	209,993	225,550	144,620	59,727
Total assets.....	325,801	492,854	485,172	321,643	89,460
Long-term obligations.....	13,837	27,070	20,852	24,761	813
Convertible subordinated notes.....	103,500	103,500	103,500	--	--
Stockholders' equity.....	\$ 163,530	\$ 270,840	\$ 260,321	\$ 205,864	\$ 68,878

</TABLE>

(1) Other operating expense for 1998 includes a write-off of acquired technologies of \$8.0 million, a charge for impairment of long-lived assets of \$27.2 million and a restructuring charge of \$6.1 million. Other operating expense for 1997 includes a charge for impairment of long-lived assets of \$17.2 million.

(2) Diluted earnings per share includes the effect of incremental shares issuable upon the conversion of the convertible subordinated notes, the dilutive effect of outstanding options and an adjustment to net income for the interest expense (net of income taxes) related to the notes unless the impact of such conversion is anti-dilutive. The effect of the conversion was anti-dilutive in 1998.

(3) For purposes of calculating the ratio of earnings to fixed charges, (i) earnings consist of consolidated income before income taxes and equity in net income of joint venture plus fixed charges and (ii) fixed charges consist of interest expense incurred and the portion of rental expense under operating leases deemed by the Company to be representative of the interest factor. Earnings were insufficient to cover fixed charges in the years ended December 31, 1998 and 1997, as evidenced by the less than 1:1 coverage ratio. Additional earnings of \$142.6 million and \$18.6 million were necessary to provide a 1:1 coverage ratio for December 31, 1998 and 1997, respectively. The Company had no fixed charges in 1995.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS

When used in this discussion, the words "expects," "anticipates," "estimates" and similar expressions are intended to identify forward-looking statements. Such statements, which include statements concerning the timing of availability and functionality of products under development, product mix, trends in average selling prices, trends in the PC market, the percentage of export sales and sales to strategic customers and the availability and cost of products from the Company's suppliers, are subject to risks and uncertainties, including those set forth below under "Factors That May Affect Our Results," that could cause actual results to differ materially from those projected. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any statement is based.

## RESULTS OF OPERATIONS

The following table sets forth for the years indicated certain financial data as a percentage of net sales:

	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Net sales.....	100.0%	100.0%	100.0%
Cost of sales.....	100.9	69.0	61.6
Gross margin (loss).....	(0.9)	31.0	38.4
Operating expenses:			
Research and development.....	35.0	18.0	14.4
Selling, marketing and administrative.....	18.7	12.8	11.1
Other operating expense.....	18.4	4.0	--
Total operating expenses.....	72.1	34.8	25.5
Income (loss) from operations.....	(73.0)	(3.8)	12.9
Gain on sale of joint venture.....	11.8	--	--
Other income (expense).....	(2.3)	(0.5)	0.5
Income (loss) before income taxes and equity in			
income of manufacturing joint venture.....	(63.5)	(4.3)	13.4
Provision (benefit) for income taxes.....	(5.3)	(2.0)	4.5
Income (loss) before equity in income of			
manufacturing joint venture.....	(58.2)	(2.3)	8.9
Equity in income from manufacturing joint venture...	7.8	4.3	0.6
Net income (loss).....	(50.4)%	2.0%	9.5%

## NET SALES

The Company's net sales to date have been generated from the sale of its graphics and multimedia accelerators. The Company's products are used in, and its business is dependent on, the personal computer industry with sales primarily in the U.S., Asia and Europe. Net sales were \$224.6 million in 1998, a decrease of 49% from \$436.4 million in 1997. Net sales for 1998 consisted primarily of the Company's 2D and 3D products. Sales decreased from 1997 to 1998 because of declining unit average selling prices due to aggressive pricing from certain of the Company's competitors, the sale of older generation products at lower prices, a significant decrease in unit volumes and the lack of products available at the high end of the market. The Company expects that the percentage of its net sales represented by any one product or type of product may change significantly from period to period as new products are introduced and existing products reach the end of their product life cycles. Due to competitive price pressures, the Company's products experience declining unit average selling prices over time, which at times can be substantial. The Company's Savage4 family of products is expected to address the mainstream graphics market.

Net sales were \$436.4 million in 1997, a 1% decrease from \$439.2 million in 1996. Net sales for 1997 consisted primarily of the Company's ViRGE and Trio families of integrated accelerators. The decrease in sales from 1996 to 1997 was a result of declining unit average selling prices due to aggressive pricing from certain of the Company's competitors as well as the sale of older generation products, offset by an increase in unit shipments.

The Company's ViRGE family of 2D/3D and Trio 3D accelerators continue to experience decreases in average selling prices. As a result of the entry of competitors into the 3D acceleration market, the Company has experienced and anticipates that it may continue to experience increased pricing pressures on average selling prices for the ViRGE family of 2D/3D and Trio 3D accelerators. If the Company is unable to introduce and successfully market higher performance products, if the Company's products do not achieve market acceptance or if the pricing pressures increase above normal anticipated levels, the Company's operating results could be adversely affected.

Export sales accounted for 89%, 70% and 58% of net sales in 1998, 1997 and 1996 respectively. Approximately 29% of export sales in 1998 were to affiliates of United States customers. The Company expects that export sales will continue to represent a significant portion of net sales, although there can be no assurance that export sales as a percentage of net sales will remain at current levels. All sales transactions are denominated in U.S. dollars.

Three customers accounted for 39%, 14% and 13% of net sales in 1998. Three customers accounted for 20%, 13% and 12% of net sales in 1997. Two customers accounted for 16% and 15% of net sales in 1996. The Company expects a significant portion of its future sales to remain concentrated within a limited number of strategic customers. Sales to any particular customer may fluctuate significantly from quarter to quarter. The Company's largest customer in 1998 was the Company's largest Asian distributor, and more than 50% of the Company's 1998 net sales were made through distributors.

#### GROSS MARGIN

The Company had a negative gross margin percentage of 1% in 1998 and gross margin percentages of 31% and 38% in 1997 and 1996, respectively. The negative gross margin in 1998 was impacted by decreases in overall average selling prices of the ViRGE and Trio family of accelerators. Also impacting the negative gross margin were charges for excess and obsolete inventory, lower of cost or market reserves established for the Company's 2D and 3D products, a \$4.0 million charge for underutilized prepaid production capacity and yield losses.

The gross margin in 1997 was impacted by decreases in overall average selling prices of the 64-bit Trio family and ViRGE family of accelerators, which resulted in part from the increased proportion of the Company's export sales to Asian customers and the substantial price competition experienced in the Asian market. In addition, the Company did not offer products addressing the high performance 3D acceleration market, which adversely affected the Company's gross margin. These factors were offset in part by the decrease in unit average costs resulting from the Company's foundries' conversion to 8-inch wafer utilizing .35 micron technology.

In the future, the Company's gross margin percentages may be affected by increased competition and related decreases in the unit average selling prices (particularly with respect to older generation products), timing of volume shipments of new products, the availability and cost of products from the Company's suppliers, changes in the mix of products sold, the extent to which the Company forfeits or utilizes its production capacity rights with TSMC, the extent to which the Company will incur additional licensing fees and shifts in sales mix between add-in card and motherboard manufacturers and systems OEMs. The Company expects gross margin to increase in 1999 as the result of new product introductions.

#### RESEARCH AND DEVELOPMENT EXPENSES

The Company has made and intends to continue to make significant investments in research and development to remain competitive by developing new and enhanced products. Research and development

expenses were \$78.6 million in 1998, \$78.6 million in 1997 and \$63.4 million in 1996. Research and development expenses for 1998 reflect approximately \$3.0 million in charges for the Company's discontinued audio and communications product lines and the write-offs of idle, excess and obsolete capital equipment associated with research and development projects terminated during the year.

Excluding these charges, research and development expenses decreased from 1997 to 1998 as a result of reductions in engineering staff due to discontinuing certain product lines during the year. The increase in research and development expenses from 1996 to 1997 reflect additions to the Company's engineering staff and initial product verification and nonrecurring engineering expenses related to the introduction of new products, including product development for the desktop, mobile and home PC markets. The Company expects research and development expenses in absolute dollars to decrease in 1999.

#### SELLING, MARKETING AND ADMINISTRATIVE EXPENSES

Selling, marketing and administrative expenses were \$41.9 million in 1998, \$55.9 million in 1997 and \$48.8 million in 1996. Selling, marketing and administrative headcount decreased by 33% and commission expense decreased by approximately \$7.0 million from 1997 to 1998. From 1996 to 1997 selling, marketing and administrative headcount increased by 8% and marketing spending increased \$3.2 million which included costs associated with the introduction of new products.

#### OTHER OPERATING EXPENSE

Other operating expense in 1998 includes a write-off of acquired technologies of \$8.0 million, a charge for impairment of long-lived assets of \$27.2 million and a restructuring charge of \$6.1 million.

In January 1998, the Company entered into a \$40.0 million technology exchange with Cirrus Logic, Inc. to obtain graphic functionality technologies. As a result of the exchange, the Company acquired the technology covered by 10 graphic patents and 25 graphic patent applications, as well as cross-licensed Cirrus Logic's remaining patents. Under the terms of the cross-licensing provisions, the Company and Cirrus Logic have a perpetual license to each other's graphic patents and additional licenses with respect to the other party's patents for agreed upon periods of time. The Company wrote-off \$8.0 million of the value of the acquired technologies that were not realizable based on estimated cash flows from the sale of products currently sold by the Company. The remaining \$32.0 million intangible asset was being amortized to cost of sales based on the estimated lives of the currently utilized core technologies, which was generally five years until the fourth quarter of 1998.

During the fourth quarter of 1998, management reevaluated the carrying value of the intangible assets recorded in connection with the technology exchange with Cirrus Logic, Inc., and related to the patents obtained from Brooktree, as well as other long-lived assets, including property and equipment. This reevaluation was necessitated by management's determination based on recent results of operations and that the future expected sales and cash flows for the Company's operations would be substantially lower than had been previously expected by management. Expected undiscounted future cash flows were not sufficient to recover the carrying value of such assets. Accordingly, an impairment loss of \$27.2 million, representing the excess of the carrying value over the estimated fair value of the assets, was recognized for write-downs of a substantial portion of the intangible assets. The estimated fair value of the intangible assets was based on management's best estimate of the patent portfolio based on a comparison to other graphics technology portfolios in the marketplace. The Company determined that no write-down of property and equipment was necessary at December 31, 1998 based on its estimate of the fair value of such assets. Due to technological changes in the graphics marketplace, the Company concluded it should accelerate its amortization of its remaining patent portfolio, of approximately \$4.0 million, over the current estimated life of the currently utilized core technologies, which is two years.

In July 1998, the Company implemented a restructuring plan in order to align resources with a new business model and to lower the Company's overall cost structure. In connection with the restructuring, the Company reduced its headcount and consolidated facilities. Severance and related benefits represented the reduction of approximately 70 employees, of which 69 have been paid and separated from the Company as of

December 31, 1998. All severance packages will be paid by the end of the second quarter of 1999. The number of temporary employees and contractors used by the Company was also reduced. The restructuring expense included the write-off and write-down in carrying value of equipment, which consists primarily of workstations, personal computers and furniture, that will no longer be utilized in the Company's operations. These assets were written down to their estimated fair value less cost to sell. Facility closure expenses were incurred as a result of the Company's plan to vacate one of two leased buildings at the

Company's headquarters facility and include leasehold improvements, furniture, fixtures and network costs. The Company plans to complete its move by the end of the second quarter of 1999.

During the fourth quarter of 1997, the Company wrote-off approximately \$17.2 million of intangible assets including certain licenses, patents and other technology, as a result of management's decision to focus attention on the core graphics business. As a result of this decision, no future cash flows were expected related to these assets.

#### GAIN ON SALE OF MANUFACTURING JOINT VENTURE

On December 31, 1997, the Company entered into an agreement with UMC to sell to UMC 80 million shares of stock of USC for a purchase price of 2.4 billion New Taiwan dollars. The Company received the purchase price (approximately \$68.0 million in cash) in January 1998 upon closing. The gain on the sale of stock in USC was \$26.6 million.

#### OTHER INCOME (EXPENSE), NET

Other expense, net, increased in 1998 to \$5.3 million from \$2.1 million in 1997. The increase was primarily the result of write-offs of certain equity investments in technology companies. Other expense, net, decreased in 1997 to \$2.1 million of expense from \$2.2 million of income in 1996. The decrease is attributable to the interest expense incurred on \$103.5 million aggregate principal amount of convertible subordinated notes, which were issued by the Company in September 1996, as well as lower average cash and short-term investments balances, which resulted in a decrease in interest income.

#### INCOME TAXES

The Company's effective tax rate for 1998 was a benefit of 8.4%, compared to the 46% and 34% effective tax rates for 1997 and 1996, respectively. The effective tax rate for 1998 reflects the expected benefits of current year loss carrybacks net of the establishment of a valuation allowance in 1998 against the beginning of the year balance of net deferred tax assets. The 1997 tax rate reflects the full benefit of operating losses at statutory rates plus the benefit of tax credits generated.

#### LIQUIDITY AND CAPITAL RESOURCES

Cash and equivalents and short-term investments increased in 1998 by \$1.9 million to \$119.6 million from \$117.7 million at the end of 1997. The Company used \$9.3 million for operating activities and used \$38.9 million for investing activities in 1998. In addition, the Company used \$11.3 million of cash for financing activities.

Cash used for operating activities was \$9.3 million in 1998, as compared to \$18.8 million in 1997. The Company's operating loss of \$113.2 million was offset by non cash charges including deferred income taxes, depreciation, amortization, loss on the disposal of equipment, write-off of prepaid production capacity, the utilization of production capacity rights, write-off of impaired assets and the write-off of acquired technologies. The Company sold a portion of its interest in USC during 1998 and recognized a gain of \$26.6 million. In addition the Company recognized \$17.5 million in income from their 15.75% equity investment in USC. The non cash charges were offset by decreases in accounts receivable and inventories of \$36.8 million and \$60.5 million, respectively. Accounts receivable decreased as a result of lower net sales by the Company while inventories decreased as the result of lower production volumes and charges taken during 1998 for excess and obsolete inventory, lower of cost or market reserves and yield losses. Accounts payable decreased as a direct result of lower inventory purchases.

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Cash used for operating activities was \$18.8 million in 1997, as compared to cash provided by operating activities of \$34.2 million in 1996. The decrease in 1997 was due to lower net income, an increase in inventories, prepaid expenses and other and a decrease in accounts payable, partially offset by a write-off of impaired assets and a decrease in accounts receivable. The increase in inventories was due to the Company's effort to reduce the amount of inventory in the channel, which resulted in increased inventories on hand at December 31, 1997. The decrease in accounts receivable was a result of lower sales in the fourth quarter of 1997 as compared to the fourth quarter of 1996.

Investing activities for the years ended December 31, 1998, 1997 and 1996 used \$38.9 million, \$6.4 million and \$120.5 million, respectively. The primary investing activities in 1998 included \$40.0 million used in a patent purchase

and cross-licensing agreement with Cirrus Logic, Inc., \$5.9 million of property and equipment purchases, \$125.4 million of short term investment purchases, offset by \$66.7 million of maturities of short-term investments and \$68.0 million from the sale of a portion of the Company's joint venture in USC. The Company's primary investing activities in 1997 included \$30.3 million of property and equipment purchases, \$16.4 million of short term investment purchases, offset by \$55.7 million of maturities of short term investments. The primary investing activities in 1996 included \$23.4 million of property and equipment purchases, \$74.8 million of short term investment purchases and a \$53.0 million investment in the USC joint venture offset by \$36.6 million of maturities of short term investments. The Company expects capital requirements for 1999 to be consistent with those for 1998.

Financing activities used cash of \$11.3 million in 1998 and provided cash of \$21.1 million and \$111.6 million in 1997 and 1996, respectively. The decrease in 1998 was primarily the result of the \$10.0 million repayment of notes payable. Financing activities in 1997 included the sales of common stock pursuant to employee stock option and stock purchase plans as well as \$10.0 million in borrowings on notes payable. This \$10.0 million source of funds in 1997 was repaid in 1998. The increase in 1996 primarily reflects the offering of \$103.5 million aggregate principal amount of convertible subordinated notes completed in September 1996. Net proceeds from the sale of the notes were approximately \$100.1 million.

In 1995, the Company entered into two long-term manufacturing capacity arrangements. The Company entered into an agreement with UMC and Alliance Semiconductor Corporation to form USC, a separate Taiwanese company, for the purpose of building and managing a semiconductor manufacturing facility in the Science Based Industrial Park in Hsin Chu City, Taiwan, Republic of China. The Company invested \$53.0 million in 1996 and \$36.4 million in 1995 for its 23.75% equity interest. On December 31, 1997, the Company entered into an agreement with UMC to sell to UMC 80 million shares of stock of USC for a purchase price of 2.4 billion New Taiwan dollars. The Company received the purchase price (approximately \$68.0 million in cash) in January 1998 upon closing. As a result of the January 1998 sale to UMC, S3's percentage ownership in USC decreased to 15.75%. Under the terms of the agreement, if at any time a "Liquidity Event" occurs, S3 will be entitled to receive, in addition to the initial payment of 2.4 billion New Taiwan dollars, a contingent payment of up to 19 New Taiwan dollars per share, or up to an additional 1.5 billion New Taiwan dollars (approximately U.S. \$46.6 million at exchange rates prevailing on December 31, 1998). A "Liquidity Event" is defined as any event by which UMC, or its successor, will have the opportunity to receive value from transfer of its ownership of shares of stock in USC in an arms-length transaction other than by way of transfer to employees for incentives, whether or not UMC or its successor, in fact, participates in such opportunity. A Liquidity Event will include, for example, completion of a public offering of USC securities on a recognized securities exchange; a sale of USC stock owned by UMC (or by a UMC successor) in an arms-length transaction; or a sale of all or substantially all of the assets of USC. The facility commenced production utilizing advanced submicron semiconductor manufacturing processes in late 1996. The Company has the right to purchase up to 31.25% of the output from the foundry. In addition, the Company expanded and formalized its relationship with TSMC to provide additional capacity over the 1996 to 2000 timeframe. The agreement with TSMC requires the Company to make certain annual advance payments to be applied against the following year's capacity. The Company has signed promissory notes to secure these payments, which total \$14.4 million as of December 31, 1998, over the term of the agreement. The Company made no payments in 1998, and paid \$9.6 million in 1997 and \$7.2 million in 1996. See Note 5 of Notes to Consolidated Financial Statements.

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Working capital at December 31, 1998 and December 31, 1997 was \$152.2 million and \$210.0 million, respectively. At December 31, 1998, the Company's principal sources of liquidity included cash and equivalents of \$31.0 million and \$88.6 million in short-term investments. At December 31, 1997, the Company's principal sources of liquidity included cash and equivalents of \$90.5 million and \$27.2 million in short-term investments. Additionally, the Company had a \$75.0 million unsecured revolving line of credit at December 31, 1997. The line of credit was cancelled during 1998. In addition, the Company had available two separate secured equipment lines of credit totaling \$10.0 million. The Company terminated these lines during 1998. The Company had \$5.6 million outstanding under these secured equipment lines of credit at December 31, 1997. The Company was required to maintain certain financial covenants in connection with these lines of credit. See Note 5 of Notes to Consolidated Financial Statements. The Company believes that its available funds will satisfy the Company's projected working capital and capital expenditure requirements for at least the next 12

months, other than expenditures for future potential manufacturing agreements.

In order to obtain an adequate supply of wafers, especially wafers manufactured using advanced process technologies, the Company has entered into and will continue to consider various possible transactions, including the use of "take or pay" contracts that commit the Company to purchase specified quantities of wafers over extended periods, equity investments in, advances or issuances of equity securities to wafer manufacturing companies in exchange for guaranteed production or the formation of joint ventures to own and operate or construct wafer fabrication facilities. Manufacturing arrangements such as these may require substantial capital investments, which may require the Company to seek additional equity or debt financing. There can be no assurance that such additional financing, if required, will be available when needed or, if available, will be on satisfactory terms. In addition, the Company may, from time to time, as business conditions warrant, invest in or acquire businesses, technology or products that complement the business of the Company.

The Company is currently a party to certain legal proceedings. Litigation could result in substantial expense to the Company. See "Item 3. Legal Proceedings."

#### YEAR 2000 COMPLIANCE

As a result of computer programs being written using two digits, rather than four, to represent year dates, the performance of the Company's computer systems and those of its suppliers and customers in the Year 2000 is uncertain. Any computer programs that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices or engage in other normal business activities.

The Company's plans to address the Year 2000 issue involve the following phases: (i) inventory/risk assessment, (ii) remediation, (iii) testing and (iv) full compliance and/or the creation of contingency plans. The Company has completed an inventory and assessment of its systems for Year 2000 readiness. The assessment indicated that most of the Company's significant information technology systems could be affected, particularly the general ledger, billing and inventory systems. That assessment also indicated that software and hardware (embedded chips) used in development, production and manufacturing systems also are at risk. Based on a review of its product line, the Company believes that its products do not require remediation to be Year 2000 compliant. Accordingly, the Company believes that the Company's products will not expose the Company to material Year 2000 related liabilities. The Company has also queried its significant supplier and subcontractors that do not share information systems with the Company ("external agents"). Although the Company is not aware of any external agent with a Year 2000 issue that would materially affect the Company's results of operations or financial condition, the failure of an external agent to be Year 2000 compliant could have a material adverse effect on the Company's results of operations or financial condition. The Company intends to periodically review its external agents to monitor their progress toward completion of their Year 2000 compliance.

The Company has completed the remediation phase for its information technology systems and expects to complete software reprogramming and replacement in the first half of 1999. Once software is reprogram-

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med or replaced for a system, the Company begins testing and implementation. These phases run concurrently for different systems. To date, the Company has completed approximately 50% of its testing. Completion of the testing phase for all remediated systems is expected to occur by the first half of 1999, with all remediated systems fully tested and implemented by the second quarter of 1999. The Company's order entry system interfaces directly with significant third party vendors. The Company is in the process of working with third party vendors to ensure that the Company's systems that interface directly with third parties are Year 2000 compliant by the third quarter of 1999.

The Company will utilize both internal and external resources to reprogram, or replace, test and implement its software and operating equipment for Year 2000 modifications. The Company believes that costs for remediation, testing and implementation are not significant.

The Company currently has no contingency plans in place in the event it does not complete all phases of the Year 2000 program. The Company plans to evaluate the status of completion by the first half of 1999 and determine

whether such a plan is necessary. The failure of either the Company's critical systems or those of its material third parties to be Year 2000 complaint would result in the interruption of its business, which could have material adverse affect on the results of operations or financial condition of the Company.

#### FACTORS THAT MAY AFFECT OUR RESULTS

##### OUR OPERATING RESULTS MAY FLUCTUATE

Our operating results have in the past varied significantly and are expected to vary significantly in the future due to several factors, some of which are beyond our control. Those factors include:

- changes in our pricing policies or those of our competitors or suppliers;
- competitive pressures on average selling prices;
- the availability and cost of products from our suppliers;
- changes in the mix of products sold by us or in the mix of distribution channels through which those products are sold;
- the timing of new product introductions by us or our competitors;
- market acceptance of new or enhanced versions of our products;
- disruptions in our production or shipping processes;
- the gain or loss of significant customers;
- seasonal customer demand;
- the operating results of USC, our manufacturing joint venture; and
- general economic conditions, including economic conditions in Asia in particular, that could affect the timing of customer orders and capital spending and result in order cancellations or rescheduling.

Some or all of those factors could adversely affect demand for our products and, therefore, our operating results, in the future.

In addition, we generally ship more products in the third month of each quarter than in either of the first two months of the quarter, with levels of shipment in the third month higher towards the end of the month. This pattern, which is common in the semiconductor industry, is likely to continue and makes future quarterly operating results less predictable.

##### WE MAY NOT RETURN TO PROFITABILITY

We had a net loss of \$113.2 million in 1998. Our net sales decreased 49% from 1997 to 1998 and we experienced a negative gross margin in 1998. These results occurred primarily because we did not offer competitive products in the high end of the graphics and multimedia accelerator market. As a result, our sales

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consisted of sales of primarily older generation and lower price products that were sold into markets that had significant price competition. We took a charge for excess and obsolete inventory. Our manufacturing yields were lower than expected which required us to take a charge for yield losses. We also took a \$4.0 million charge for underutilized prepaid production capacity. We may not be able to return to profitability.

##### OUR PRODUCTS ARE SUBJECT TO SIGNIFICANT PRICING PRESSURES

Prices for graphics accelerators tend to decline over time, and prices for newly introduced products are under significant pricing pressures due in part to aggressive pricing from some of our competitors. We have experienced and anticipate that we will continue to experience increased pricing pressures on average selling prices for our ViRGE, Trio and Savage families of accelerators.

##### WE HAVE ONLY RECENTLY STARTED TO OFFER A PRODUCT THAT SPANS ALL VOLUMES OF THE COMMERCIAL AND CONSUMER PC MARKET

The graphics accelerator market is transitioning from 2D acceleration to 3D acceleration and products that compete in the high performance segment of that

market have higher gross margins than products in the mainstream PC or in the sub-\$1,000, or "segment zero," PC market. We commenced shipment of our Savage3D product during the third quarter of 1998. This product was intended to address the high performance 3D acceleration market. However, the Savage3D failed to achieve significant market acceptance. We have recently introduced our Savage4, which is designed to compete in multiple performance segments of the commercial and consumer PC markets of the 3D acceleration market. We do not know whether Savage4 will be able to compete successfully in that segment. If we are not able to introduce and successfully market higher performance products, our gross margin and profitability could be negatively affected.

#### WE MAY NOT ADEQUATELY FORECAST DEMAND FOR OUR PRODUCTS

Because we are "fabless" and must order products and build inventory substantially in advance of product shipments, and because the markets for the our products are volatile and subject to rapid technological and price changes, we might forecast product demand incorrectly and produce excessive or insufficient inventories of particular products. In addition, our customers may change delivery schedules or cancel orders without significant penalty. If we produce excessive or insufficient inventories of particular products, our operating results could be negatively affected, as they were in 1998.

#### WE FACE SUBSTANTIAL COMPETITION

The market for our products is extremely competitive and is characterized by declining selling prices over the life of a particular product and rapid technological changes. Our principal competitors for graphics accelerators include 3DFX Interactive, Inc., ATI Technologies, Inc., Intel Corporation, Matrox Graphics Inc., NVIDIA Corporation, and Trident Microsystems, Inc. Our principal competitors in the multimedia market include the companies just named as well as a number of smaller companies that may have greater flexibility to address specific market needs. Potential competitors in these markets include both large and emerging domestic and foreign semiconductor companies. In particular, there are a significant number of established and emerging companies that have developed, are developing or have announced plans to develop 3D graphics chips. Our product offerings may not address the demand for the next generation of accelerators or be competitive. If we expand our product line to add products with additional functionality, we will encounter substantial competition from established semiconductor companies and may experience competition from companies designing chips based on different technologies.

Furthermore, the need of PC manufacturers to rapidly introduce a variety of products aimed at different segments of the PC market may lead to the shift by system OEMs to the purchase of graphics and multimedia add-in cards provided by others. Some of our competitors supply both add-in cards and accelerator chips, which may provide those competitors with an advantage over suppliers that offer only accelerator chips. In addition, some of our potential competitors, such as Intel, that supply add-in cards and/or motherboards may seek to use their card/board business to leverage their graphics accelerator business. Some of our current and

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potential competitors have greater technical, manufacturing, financial and marketing resources than we do. We believe that our ability to compete successfully will depend upon a number of factors both within and outside of our control, including:

- product performance and quality;
- product features;
- product availability;
- the prices that we charge;
- the timing of new product introductions by us and our competitors;
- the emergence of new graphics and PC standards;
- the level of customer support we offer; and
- industry and general economic trends.

We may not have the financial resources, technical expertise or marketing, distribution and support capabilities to compete successfully.

The PC industry in general, and the market for our products in particular, is characterized by rapidly changing technology, evolving industry standards and frequent new product introductions. Products in our market typically have a life cycle of 12 to 18 months, with regular reductions of unit average selling prices over the life of a specific product. The successful development and commercialization of new products required to replace or supplement existing products involve many risks, including the identification of new product opportunities, the successful and timely completion of the development process and the selection of our products by leading systems suppliers and add-in card and motherboard manufacturers for design into their products. There can be no assurance that we will successfully identify new product opportunities and develop and bring to market new products in a timely manner. Furthermore, there can be no assurance that products or technologies developed by others will not render our products or technologies noncompetitive, or that our products will be selected for design into its customers' products.

Our products are designed to improve the graphics and multimedia performance of Pentium-based PCs and Microsoft Windows, Windows NT and IBM OS/2 operating systems. We expect that additional specialized graphics processing and general purpose computing capabilities will be integrated into future versions of Intel and other Pentium-based microprocessors and that standard multimedia accelerators in the future will likely integrate memory, system logic, audio, communications or other additional functions. In particular, Intel has announced plans to develop chips that integrate graphics and processor functions to serve the lower cost PC market. A substantial portion of our 1998 sales were derived from products addressing the lower cost PC market, and we anticipate that a substantial portion of our 1999 sales will also be derived from products addressing that market. We have not previously offered either single function or integrated accelerator products that provide these functions, which have traditionally been provided by separate single function chips or chipsets. We have and will continue to expand the scope of our research and development efforts to provide these functions, which will require the hiring of engineers skilled in the respective areas and additional management and coordination among our design and engineering groups. Alternatively, we may find it necessary or desirable to license or acquire technology to enable us to provide these functions, and there can be no assurance that any such technology will be available for license or purchase on terms acceptable to us.

Furthermore, there is a limited amount of space on PC motherboards, and companies that offer solutions that provide the greatest amount of functionality within this limited space may have a competitive advantage. While our strategy is to develop new and enhanced graphics and multimedia accelerator products that will be complementary to present and future versions of Intel and other Pentium-based microprocessors and integrate

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additional functionality, there can be no assurance that we will be able to develop such new or enhanced products in a timely manner or correctly anticipate the additional functionality that will be needed to compete effectively in this market. Our initial product containing a number of additional functions, Plato/PX, has been discontinued. There can be no assurance that, if developed, our new or enhanced products that incorporate additional functions will achieve market acceptance.

We are continually developing new products, such as Savage4, to address changing market needs. If new products are not brought to market in a timely manner or do not address market needs or achieve market acceptance, then our operating results could be negatively affected. Market acceptance of our products depends upon a number of factors, some of which are significantly beyond our control, such as the acceptance of other components, such as memory, that our products are designed to work with.

#### WE MUST KEEP PACE WITH EVOLVING INDUSTRY STANDARDS

Our products are designed to improve the graphics and multimedia performance of Pentium-based PCs and Microsoft Windows, Windows NT and IBM OS/2 operating systems, the predominant standards in today's PC market. Any shift away from such standards would require us to develop new products. We cannot be certain that new technological developments or changes in standards will not result in decreased demand for graphics and multimedia accelerators or for our products that are not compatible with such changed standards.

In 1996, for example, there was an absence of an industry standard 3D graphics API. As a result, we developed and promoted our proprietary API.

Microsoft has since introduced its Direct3D API and Silicon Graphics has introduced OpenGL, which have emerged as the standard APIs for 3D acceleration. While our 3D accelerators currently support our proprietary API, Direct 3D API and OpenGL, it is possible that another API will emerge as an industry standard and that our accelerators will not support such a new standard, which would have a materially negative effect on our business, financial condition and results of operations.

Furthermore, due to the widespread industry acceptance of Intel's microprocessor architecture and interface architecture, including its AGP bus, Intel exercises significant influence over the PC industry generally. From time to time, Intel significantly modifies its existing technology, architecture and standards. If we fail to develop products that are compatible with such modifications, that failure would have a material adverse effect on our business, financial condition and results of operations. Likewise, any delay in the public release of information relating to any such modifications could have a material adverse effect on us.

WE ARE A FABLESS SEMICONDUCTOR COMPANY AND DEPEND ON INDEPENDENT FOUNDRIES FOR THE MANUFACTURE OF OUR PRODUCTS

We currently rely on two independent foundries to manufacture all of our products either in finished form or wafer form. We have a "take or pay" contract with Taiwan Semiconductor Manufacturing Company ("TSMC") and a joint venture foundry, United Semiconductor Corporation ("USC"). In 1995, we expanded and formalized our relationship with TSMC to provide additional capacity over the 1996 to 2000 time frame. The foundry agreement with TSMC requires us to make certain annual advance payments to purchase certain committed capacity amounts to be applied against the following year's capacity or forfeit advance payments against such amounts. In the fourth quarter, we wrote off approximately \$4.0 million of the 1998 prepaid production capacity because we did not fully utilize the capacity related to the advance payment. Our current note payable to TSMC is \$14.4 million. During 1998, we commenced negotiations with TSMC to modify and amend the foundry agreement. Although the terms have not been finalized, we are requesting TSMC to reduce its option capacity and extend the term of the agreement. If we purchase excess inventories of particular products or choose to forfeit advance payments, our operating results could be negatively affected.

We conduct business with one of our current foundries by delivering written purchase orders specifying the particular product ordered, quantity, price, delivery date and shipping terms. This foundry is therefore not obligated to supply products to us for any specific period, in any specific quantity or at any specific price, except as may be provided in a particular purchase order. To the extent a foundry terminates its relationship with us or our supply from a foundry is interrupted or terminated for any other reason, such as a natural

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disaster or an injunction arising from alleged violations of third party intellectual property rights, we may not have a sufficient amount of time to replace the supply of products manufactured by that foundry. There can be no assurance that we will obtain sufficient advanced process technology foundry capacity to meet customer demand in the future. From time to time we may evaluate potential new sources of supply. However, the qualification process and the production ramp-up for additional foundries has in the past taken, and could in the future take, longer than anticipated, and there can be no assurance that such sources will be able or willing to satisfy our requirements on a timely basis or at acceptable quality or per unit prices.

TSMC and USC are both located in the Science-Based Industrial Park in Hsin Chu City, Taiwan. We currently expect these foundries to supply the substantial portion of our products in 1999. Disruption of operations at these foundries for any reason, including work stoppages, fire, earthquakes or other natural disasters, would cause delays in shipments of our products, and could have a material adverse effect on our operating results. In addition, as a result of the rapid growth of the semiconductor industry based in the Science-Based Industrial Park, severe constraints have been placed on the water and electricity supply in that region. Any shortages of water or electricity could adversely affect our foundries' ability to supply our products, which could have a material adverse effect on our operating results.

WE ARE SUBJECT TO THE RISK OF OPERATING LOSSES FROM OUR JOINT VENTURE

We currently own 15.75% of USC and maintain the right to purchase up to 31.25% of USC's output. If USC experiences operating losses, we will recognize our proportionate share of those losses and may be required to contribute additional capital. We believe that a number of manufacturers are expanding or planning to expand their fabrication capacity over the next several years, which

could lead to over-capacity in the market and resulting decreases in costs of finished wafers. If the wafers produced by USC cannot be produced at competitive prices, USC could sustain operating losses. There can be no assurance that these operating losses will not have a material adverse effect on our operating results.

#### WE RELY ON THIRD PARTIES TO ASSEMBLE AND TEST OUR PRODUCTS

Our products are assembled and tested by a variety of independent subcontractors. Our reliance on independent assembly and testing houses to provide these services involves a number of risks, including the absence of adequate availability of certain packaging technologies, the absence of guaranteed capacity and reduced control over delivery schedules, quality assurance and costs.

#### COMMITMENTS WE HAVE MADE TO OBTAIN MANUFACTURING CAPACITY COULD EXPOSE US TO SIGNIFICANT FINANCIAL RISKS AND GIVE RISE TO FUTURE CAPITAL NEEDS

In order to obtain an adequate supply of wafers, especially wafers manufactured using advanced process technologies, we have entered into and may consider in the future various transactions, including:

- the use of "take or pay" contracts that commit us to purchase specified quantities of wafers over extended periods;
- equity investments in or advances or issuances of equity securities to wafer manufacturing companies in exchange for guaranteed production capacity; or
- the formation of joint ventures to own and operate or construct foundries or to develop certain products.

Any such transactions would involve financial risk to us and could require us to commit substantial capital or provide technology licenses in return for guaranteed production capacity.

In particular, we have entered into a "take or pay" contract with TSMC and have entered into the USC joint venture. The need to commit substantial capital may require us to seek additional equity or debt financing. Although we currently believe that the need for such additional capital will be minimal for the next two years, if such capital is needed, the sale or issuance of additional equity or convertible debt securities could result in additional dilution to our stockholders. There can be no assurance that such additional financing, if

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required, will be available when needed or, if available, will be on terms acceptable to us. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources" and "Business -- Manufacturing and Design Methodology."

#### OUR SALES ARE CONCENTRATED WITHIN A LIMITED NUMBER OF CUSTOMERS

We expect a significant portion of our future sales to remain concentrated within a limited number of strategic customers. This concentration is reflected in our accounts receivable where greater than 75% of the balance is represented by three customers at December 31, 1998.

Three customers, Synnex Technology, Inc. ("Synnex"), IBM Corporation and Promate Electronic Co. ("Promate"), accounted for 39%, 14% and 13%, respectively, of net sales in 1998. Three customers, Synnex, CNW International Limited ("CNW"), and Compaq Computer Corporation, accounted for 20%, 13% and 12%, respectively, of net sales in 1997. Two customers, Diamond Multimedia Systems, Inc. and Synnex, accounted for 16% and 15%, respectively, of net sales in 1996. Synnex, Promate and CNW are distributors. We expect a significant portion of our future sales to remain concentrated within a limited number of strategic customers. There can be no assurance that we will be able to retain our strategic customers or that these customers will not otherwise cancel or reschedule orders, or in the event of canceled orders, that such orders will be replaced by other sales.

#### OUR SALES MAY BE HURT BY SHORTAGES OF COMPONENTS AND PRODUCT DEFECTS

PC graphics and multimedia subsystems include, in addition to our products, a number of other components that are supplied by third-party manufacturers. Any shortage of such components in the future could negatively impact our business

and operating results.

Furthermore, it is possible that our products may be found to be defective after we have already shipped significant volumes. If that were to occur, there can be no assurance that we would be able to correct such defects successfully or that such corrections would be acceptable to our customers. The occurrence of such an event could have a materially negative effect on our business and operating results.

#### WE DEPEND ON SALES THROUGH DISTRIBUTORS

A substantial percentage of our products are distributed in the distribution channel through add-in card manufacturers that in turn sell to Value Added Resellers ("VARs"), System Integrators ("SI"), Original Equipment Manufacturers ("OEM") and distributors. Accordingly, we are dependent upon these add-in card manufacturers to assist in promoting market acceptance of our products. The board manufacturers that purchase our products are generally not committed to make future purchases of our products and therefore could discontinue incorporating our products into their graphics boards in favor of a competitor's product, or for any other reason.

In addition, our distributors are given limited rights to return to us the products purchased by them, and we provide our distributors with price protection in the event that we reduce the price of our products.

#### NEARLY ALL OF OUR SALES ARE MADE ON THE BASIS OF PURCHASE ORDERS

Nearly all of our sales are made on the basis of purchase orders rather than long-term agreements. As a result, we may commit resources to the production of products without having received advance purchase commitments from customers. Any inability to sell products to which we have devoted significant resources could have a material adverse effect on our business, financial condition or operating results. In addition, cancellation or deferral of product orders could result in us holding excess inventory, which could have a material adverse effect on our profit margins and restrict our ability to fund our operations.

#### WE MAY NOT BE ABLE TO PROTECT OUR INTELLECTUAL PROPERTY RIGHTS AND PROPRIETARY INFORMATION

Our ability to compete is affected by our ability to protect our intellectual property rights and proprietary information. We have filed several United States and foreign patent applications and to date have a number of

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issued United States patents. We rely primarily on our trade secrets and technological know-how in the conduct of our business. The steps taken by us to protect our intellectual property might not be adequate to prevent misappropriation of our technology. Also, our competitors might independently develop technologies that are substantially equivalent or superior to our technology. The semiconductor and software industries are characterized by frequent claims and related litigation regarding patent and other intellectual property rights. We are party to various claims of this nature. Although the ultimate outcome of these matters is not presently determinable, our management presently believes that the resolution of all such pending matters will not have a material adverse effect on our operating results. There can be no assurance that third parties will not assert additional claims or initiate litigation against us, our foundries or our customers with respect to existing or future products. In addition, we may initiate claims or litigation against third parties for infringement of our proprietary rights or to determine the scope and validity of our proprietary rights or those of others.

Litigation by or against us has in the past resulted in, and could in the future result in, substantial expense to us and diversion of the efforts of our technical and management personnel, whether or not litigation is determined in favor of us. In the event of an adverse result in any such litigation, we could be required to pay substantial damages, cease the manufacture, use, sale, offer for sale and importation of infringing products, expend significant resources to develop or obtain non-infringing technology, discontinue the use of certain processes or obtain licenses to the technology which is the subject of the litigation. There can be no assurance that we would be successful in such development or acquisition or that any such licenses, if available, would be available on commercially reasonable terms, and any such development or acquisition could require expenditures by us of substantial time and other resources. Any such litigation or unfavorable outcome of litigation could have a material adverse effect on our operating results. For example, in October 1995, Brooktree alleged that certain of our products infringed a Brooktree patent. The

resulting lawsuit resulted in substantial expense to us to defend the action and diverted the efforts of our technical and management personnel. In a settlement of that suit, we agreed to pay to Brooktree a license fee and royalties relating to certain product revenues over a five-year period.

#### WE MUST ATTRACT, INTEGRATE, TRAIN AND RETAIN KEY PERSONNEL KNOWLEDGEABLE ABOUT OUR BUSINESS

Our future success depends in part on the continued service of certain key engineering, sales, marketing and executive personnel, including highly skilled semiconductor design personnel and software developers, and our ability to identify and hire additional personnel. Competition for such personnel is intense, particularly in the technology sectors and in the regions where our facilities are located. We cannot be certain that we will be able to retain existing personnel or attract, hire or retain additional qualified personnel. The loss of services of any of our senior management team or other key employees or our failure to attract, integrate, train and retain additional key employees could harm our business.

#### WE HAVE RECENTLY UNDERGONE A MANAGEMENT TRANSITION

In November 1998, we appointed Kenneth F. Potashner as President and Chief Executive Officer. Our Board of Directors also increased the size of the board by one, elected Mr. Potashner to fill the newly created vacancy and elected Mr. Potashner Chairman of the Board. Terry N. Holdt, who returned from his retirement in January 1998 to assume the role of interim President, Chief Executive Officer and Chairman of the Board, remains as Vice Chairman of our Board of Directors. There can be no assurance as to the effects of this management transition on our business and operating results. The loss of key personnel could have a material adverse effect on our business and operating results. We do not maintain key man insurance on any of our employees.

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#### WE HAVE SIGNIFICANT EXPOSURE TO INTERNATIONAL MARKETS

Export sales accounted for 89%, 70% and 58% of our net sales in 1998, 1997 and 1996, respectively, and we expect that export sales will continue to represent a significant portion of net sales, although there can be no assurance that export sales, as a percentage of net sales, will remain at current levels. In addition, a substantial proportion of our products are manufactured, assembled and tested by independent third parties in Asia. As a result, we are subject to the risks of conducting business internationally, including:

- unexpected changes in, or impositions of, legislative or regulatory requirements;
- fluctuations in the U.S. dollar, which could increase the price in local currencies of our products in foreign markets or increase the cost of wafers purchased by us;
- delays resulting from difficulty in obtaining export licenses for certain technology;
- tariffs and other trade barriers and restrictions;
- potentially longer payment cycles;
- greater difficulty in accounts receivable collection;
- potentially adverse tax treatment; and
- the burdens of complying with a variety of foreign laws.

We have experienced an adverse impact associated with the economic downturn in Asia which contributed to our decrease in net sales in 1998. In addition, our international operations are subject to general geopolitical risks, such as political and economic instability and changes in diplomatic and trade relationships. Our foundries, TSMC and USC, are located in Taiwan. The People's Republic of China and Taiwan at times experienced strained relations in 1995 and 1996, and a worsening of relations or the development of hostilities between the two parties could have a material adverse effect on us. Finally, the laws of certain foreign countries may not protect our intellectual property rights to the same extent as do the laws of the United States.

#### WE HAVE A SIGNIFICANT LEVEL OF DEBT

As a result of the sale by us of \$103,500,000 aggregate principal amount of Convertible Subordinated Notes in September 1996, our ratio of long-term debt to total capitalization increased from approximately 9.5% at June 30, 1996 to approximately 31.2% at December 31, 1996. At December 31, 1998, this ratio increased to 38.8%. The increase in this ratio is the result of the decrease in the Company's total capitalization as the result of its net loss for 1998. The degree to which we are leveraged could adversely affect our ability to obtain additional financing for working capital or other purposes and could make us more vulnerable to economic downturns and competitive pressures. Our increased leverage could also adversely affect our liquidity, as a substantial portion of available cash from operations may have to be applied to meet debt service requirements. In the event of a cash shortfall, we could be forced to reduce other expenditures to be able to meet such debt service requirements. See "Selected Consolidated Financial Data," and "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

#### OUR STOCK PRICE IS HIGHLY VOLATILE

The market price of our common stock, like that of the common stock of many other semiconductor companies, has been and is likely to be highly volatile. This volatility may result from:

- general market conditions and market conditions affecting technology and semiconductor stocks generally;
- actual or anticipated fluctuations in our quarterly operating results;

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- announcements of design wins, technological innovations, acquisitions, investments or business alliances; and
- the commencement of, developments in or outcome of litigation.

The market price of our common stock also has been and is likely to continue to be significantly affected by expectations of analysts and investors, especially if our operating results do not meet those expectations. Reports and statements of analysts do not necessarily reflect our views. The fact that we have in the past met or exceeded analyst or investor expectations does not necessarily mean that we will do so in the future.

In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought. Such litigation could result in substantial costs and a diversion of our management's attention and resources. Such litigation was brought against the Company in 1994 and the Company is currently involved in another such proceeding. See "Item 3. -- Legal Proceedings."

#### WE ARE PARTY TO LEGAL PROCEEDINGS ALLEGING SECURITIES VIOLATIONS THAT COULD HAVE A NEGATIVE FINANCIAL IMPACT ON US

Since November 1997, a number of complaints have been filed in federal and state courts seeking an unspecified amount of damages on behalf of an alleged class of persons who purchased shares of our common stock at various times between April 18, 1996 and November 3, 1997. The complaints name us as defendants as well as certain of our officers and former officers and certain of our directors, asserting that we and they violated federal and state securities laws by misrepresenting and failing to disclose certain information about our business. In addition, certain shareholders have filed derivative actions in the state courts of California and Delaware seeking recovery on our behalf, alleging, among other things, breach of fiduciary duties by such individual defendants. Discovery is currently proceeding. While our management intends to defend the actions against us vigorously, there can be no assurance that an adverse result or settlement with regards to these lawsuits would not have a material adverse effect on our financial condition or results of operations.

We have also received from the United States Securities and Exchange Commission ("SEC") a request for information relating to our financial restatement announcement in November 1997. We have responded and intend to continue to respond to the SEC requests.

#### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

##### INVESTMENT PORTFOLIO

The Company does not use derivative financial instruments in its investment

portfolio. The Company places its investments in instruments that meet high credit quality standards, as specified in the Company's investment policy. The Company also limits the amount of credit exposure to any one issue, issuer or type of investment. The Company does not expect any material loss with respect to its investment portfolio.

The table below summarizes the Company's investment portfolio. The table represents principal cash flows and related average fixed interest rates by expected maturity date. The Company's policy requires that all investments mature within twenty months.

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Principal (Notional) Amounts Maturing in 1999 in U.S. Dollars:

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	FAIR VALUE AT DECEMBER 31, 1998
	(IN THOUSANDS, EXCEPT INTEREST RATES)
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At December 31, 1998:	
Cash and equivalents.....	\$ 31,022
Weighted average interest rate.....	4.94%
Short term-investments.....	\$ 88,553
Weighted average interest rate.....	5.67%
Total portfolio.....	\$119,575
Weighted average interest rate.....	5.48%

</TABLE>

CONVERTIBLE SUBORDINATED NOTES

In September 1996, the Company completed a private placement of \$103.5 million aggregate principal amount of convertible subordinated notes. The notes mature in 2003. Interest is payable semi-annually at 5 3/4% per annum. The notes are convertible at the option of the note holders into the Company's common stock at an initial conversion price of \$19.22 per share, subject to adjustment. Beginning in October 1999, the notes are redeemable at the option of the Company at an initial redemption price of 102% of the principal amount. The fair value of the convertible subordinated notes at December 31, 1998 was approximately \$76.75 million.

IMPACT OF FOREIGN CURRENCY RATE CHANGES

The Company invoices its customers in US dollars for all products. The Company is exposed to foreign exchange rate fluctuations as the financial results of its foreign subsidiaries are translated into US dollars in consolidation. The foreign subsidiaries maintain their accounts in the local currency of the foreign location in order to centralize the foreign exchange risk with the parent company. To date this risk has not been material.

The effect of foreign exchange rate fluctuations on the Company's financial statements for the years ended December 31, 1998 and 1997 was not material. Since foreign currency exposure increases as intercompany receivables grow, the Company is using foreign exchange forward contracts as a means for hedging these balances. In general, these foreign exchange forward contracts mature in three months. As of December 31, 1998, the Company held the following forward exchange contracts which mature within three months:

<TABLE>  
<CAPTION>

	NOTIONAL	FAIR VALUE
	(IN THOUSANDS)	
	<C>	<C>
<S>		
Foreign Currency Forward Exchange Contracts:		
1,500,000 Singapore Dollars.....	\$879	\$25

</TABLE>

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS OF S3 INCORPORATED

<TABLE>  
<CAPTION>

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INDEX TO FINANCIAL STATEMENTS OF UNITED SEMICONDUCTOR CORPORATION

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United Semiconductor Corporation Statement of Cash Flows for the Years Ended December 31, 1998 and 1997.....	59
United Semiconductor Corporation Notes to Financial Statements.....	60

</TABLE>

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders  
S3 Incorporated

We have audited the accompanying consolidated balance sheet of S3 Incorporated as of December 31, 1998, and the related consolidated statements of operations, stockholders' equity and cash flows for the year then ended. Our audit also included the financial statement schedule for the year ended December 31, 1998 listed in the Index at Item 14(a)(2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit. The financial statements of United Semiconductor Corporation (a corporation in which the Company has a 15.75% interest), have been audited by other auditors whose report has been furnished to us; insofar as our opinion on the consolidated financial statements relates to data included for United Semiconductor Corporation, it is based solely on their report.

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

In our opinion, based on our audit and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of S3 Incorporated at December 31, 1998, and the consolidated results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

San Jose, California  
January 21, 1999

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## REPORT OF DELOITTE &amp; TOUCHE LLP, INDEPENDENT AUDITORS

Board of Directors and Stockholders  
S3 Incorporated:

We have audited the accompanying consolidated balance sheet of S3 Incorporated and subsidiaries as of December 31, 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the two years in the period ended December 31, 1997. Our audits also included the financial statement schedule at Item 14(a)(2) for the years ended December 31, 1997 and 1996. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We did not audit the financial statements of United Semiconductor Corporation ("USC"), the Company's investment in which is accounted for by use of the equity method. The Company's equity of \$104,465,000 in USC's net assets at December 31, 1997, and of \$19,012,000 in that company's net income (after investor's applicable taxes) for the year then ended are included in the accompanying financial statements. The financial statements of USC were audited by other auditors whose report was furnished to us, and our opinion, insofar as it relates to the amounts included for such company, is based solely on the report of such other auditors.

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

In our opinion, based on our audits and the report of the other auditors, such consolidated financial statements present fairly, in all material respects, the financial position of S3 Incorporated and subsidiaries at December 31, 1997, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 1997 in conformity with generally accepted accounting principles. Also, in our opinion, the financial statement schedule for the years ended December 31, 1997 and 1996, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP  
San Jose, California  
January 23, 1998

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## S3 INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS  
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

<TABLE>  
<CAPTION>

	YEAR ENDED DECEMBER 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Net sales.....	\$ 224,639	\$436,359	\$439,243
Cost of sales.....	226,711	301,185	270,367
Gross margin (loss).....	(2,072)	135,174	168,876
Operating expenses:			
Research and development.....	78,566	78,612	63,382

Selling, marketing and administrative.....	41,926	55,879	48,800
Other operating expense.....	41,335	17,180	--
	-----	-----	-----
Total operating expenses.....	161,827	151,671	112,182
	-----	-----	-----
Income (loss) from operations.....	(163,899)	(16,497)	56,694
Gain on sale of joint venture.....	26,561	--	--
Interest income.....	7,253	5,295	4,328
Interest expense.....	(6,235)	(6,477)	(1,971)
Other income (expense).....	(6,309)	(952)	(128)
	-----	-----	-----
Income (loss) before income taxes and equity in income of manufacturing joint venture.....	(142,629)	(18,631)	58,923
Provision (benefit) for income taxes.....	(11,956)	(8,497)	19,792
	-----	-----	-----
Income (loss) before equity in income of manufacturing joint venture.....	(130,673)	(10,134)	39,131
Equity in income from manufacturing joint venture.....	17,469	19,012	2,457
	-----	-----	-----
Net income (loss).....	\$ (113,204)	\$ 8,878	\$ 41,588
	=====	=====	=====
Per share amounts:			
Basic.....	\$ (2.22)	\$ 0.18	\$ 0.88
Diluted.....	\$ (2.22)	\$ 0.17	\$ 0.81
Shares used in computing per share amounts:			
Basic.....	51,078	49,519	47,460
Diluted.....	51,078	51,740	52,451

</TABLE>

See accompanying notes to consolidated financial statements.

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S3 INCORPORATED

CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS, EXCEPT SHARES AND PER SHARE DATA)

ASSETS

<TABLE>

<CAPTION>

	DECEMBER 31,	
	1998	1997
	-----	-----
<S>	<C>	<C>
Current assets:		
Cash and equivalents.....	\$ 31,022	\$ 90,484
Short-term investments.....	88,553	27,186
Accounts receivable (net of allowances of \$6,525 in 1998 and \$5,664 in 1997).....	23,864	60,713
Inventories.....	11,383	71,882
Production capacity rights.....	15,709	19,200
Prepaid taxes.....	20,203	8,367
Prepaid expenses and other.....	6,444	23,605
	-----	-----
Total current assets.....	197,178	301,437
Property and equipment -- net.....	22,392	46,628
Production capacity rights.....	--	4,800
Investment in joint venture.....	88,056	104,465
Other assets.....	18,175	35,524
	-----	-----
Total.....	\$325,801	\$492,854
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable.....	\$ 16,315	\$ 42,819
Notes payable.....	14,400	25,246
Accrued compensation and benefits.....	6,491	8,888
Accrued liabilities.....	5,823	3,570
Deferred revenue.....	1,905	10,921
	-----	-----
Total current liabilities.....	44,934	91,444
Notes payable.....	--	4,800
Other liabilities.....	13,837	22,270
Convertible subordinated notes.....	103,500	103,500

Commitments and contingencies (Notes 7 and 11)

Stockholders' equity:

Preferred stock, \$.0001 par value; 5,000,000 shares authorized; none outstanding.....	--	--
Common stock, \$.0001 par value; 70,000,000 shares authorized; 51,716,171, and 50,549,279, shares outstanding in 1998 and 1997 respectively.....	5	5
Additional paid-in capital.....	191,642	187,271
Accumulated other comprehensive loss.....	(14,755)	(16,278)
Retained earnings (accumulated deficit).....	(13,362)	99,842
	-----	-----
Total stockholders' equity.....	163,530	270,840
	-----	-----
Total.....	\$325,801	\$492,854
	=====	=====

</TABLE>

See accompanying notes to consolidated financial statements.

S3 INCORPORATED

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(IN THOUSANDS, EXCEPT SHARES)

<TABLE>  
<CAPTION>

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED	RETAINED	TOTAL
	SHARES	AMOUNT		OTHER COMPREHENSIVE INCOME (LOSS)	EARNINGS (ACCUMULATED DEFICIT)	
<S>	<C>	<C>	<C>	<C>	<C>	<C>
BALANCE AT DECEMBER 31, 1995.....	46,797,327	\$5	\$156,469	\$ 14	\$ 49,376	\$ 205,864
Comprehensive Income						
Net income.....	--	--	--	--	41,588	41,588
Other comprehensive loss, net of tax: Change in unrealized loss on investments...	--	--	--	(68)	--	(68)
						-----
Other comprehensive loss.....						(68)
						-----
Comprehensive income.....						41,520
Exercise of stock options.....	1,204,235	--	4,550	--	--	4,550
Employee stock purchase plan.....	231,161	--	2,467	--	--	2,467
Tax benefit of stock option transactions.....	--	--	4,725	--	--	4,725
Stock compensation plan....	99,071	--	1,195	--	--	1,195
	-----	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 1996.....	48,331,794	5	169,406	(54)	90,964	260,321
Comprehensive loss						
Net income.....	--	--	--	--	8,878	8,878
Other comprehensive loss, net of tax: Change in unrealized gain on investments.....	--	--	--	3,720	--	3,720
Change in foreign currency translation adjustment.....	--	--	--	(19,944)	--	(19,944)
						-----
Other comprehensive loss.....						(16,224)
						-----
Comprehensive loss.....						(7,346)
Exercise of stock options.....	1,703,768	--	8,796	--	--	8,796
Employee stock purchase plan.....	414,646	--	3,180	--	--	3,180

Tax benefit of stock option transactions.....	--	--	3,825	--	--	3,825
Stock compensation plan....	99,071	--	2,064	--	--	2,064
	-----	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 1997.....	50,549,279	5	187,271	(16,278)	99,842	270,840
Comprehensive loss						
Net loss.....	--	--	--	--	(113,204)	(113,204)
Other comprehensive income, net of tax:						
Change in unrealized loss on investments.....	--	--	--	(5,995)	--	(5,995)
Change in foreign currency translation adjustment.....	--	--	--	7,518	--	7,518
						-----
Other comprehensive income.....						1,523
						-----
Comprehensive loss.....						(111,681)
Exercise of stock options.....	560,546	--	1,984	--	--	1,984
Employee stock purchase plan.....	606,346	--	2,387	--	--	2,387
	-----	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 1998.....	51,716,171	\$5	\$191,642	\$ (14,755)	\$ (13,362)	\$ 163,530
	=====	==	=====	=====	=====	=====

</TABLE>

See accompanying notes to consolidated financial statements.

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S3 INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

<TABLE>

<CAPTION>

	YEAR ENDED DECEMBER 31,		
	1998	1997	1996
	-----	-----	-----
<S>	<C>	<C>	<C>
OPERATING ACTIVITIES			
Net income (loss).....	\$ (113,204)	\$ 8,878	\$ 41,588
Adjustments to reconcile net income to net cash provided by (used for) operating activities:			
Deferred income taxes.....	15,453	5,432	(10,469)
Depreciation.....	18,844	15,504	10,713
Amortization.....	8,347	2,987	--
Write-off of prepaid production capacity.....	4,000	--	--
Utilization of production capacity rights.....	4,291	(2,400)	(7,200)
Loss on disposal of property and equipment.....	11,308	2,214	--
Write-off of impaired assets.....	27,226	17,180	--
Write-off of acquired technologies.....	8,000	--	--
Gain on sale of shares of joint venture.....	(26,561)	--	--
Stock compensation.....	--	2,064	1,195
Equity in income from joint venture.....	(17,469)	(30,962)	(3,999)
Changes in assets and liabilities:			
Accounts receivable.....	36,849	15,407	8,090
Inventories.....	60,499	(18,416)	(10,173)
Prepaid expenses and other.....	1,158	(25,451)	(6,975)
Accounts payable.....	(26,573)	(8,341)	(10,921)
Accrued compensation and benefits.....	(2,397)	(1,574)	(802)
Accrued liabilities.....	1,515	3,362	5,237
Deferred revenue.....	(9,015)	(1,192)	12,079
Income taxes payable.....	(11,576)	(3,536)	5,810
	-----	-----	-----
Net cash provided by (used for) operating activities...	(9,305)	(18,844)	34,173
	-----	-----	-----
INVESTING ACTIVITIES			
Property and equipment purchases, net.....	(5,916)	(30,299)	(23,403)
Purchases of short-term investments.....	(125,406)	(16,404)	(74,798)

Maturities of short-term investments.....	66,691	55,705	36,592
Investment in real estate partnership.....	--	--	(2,100)
Sale of joint venture.....	68,025	--	--
Equity investment in technology company.....	--	(5,000)	--
Investment in joint venture.....	--	--	(53,006)
Purchase of technology.....	(40,000)	--	--
Other assets.....	(2,276)	(10,412)	(3,778)
	-----	-----	-----
Net cash used for investing activities.....	(38,882)	(6,410)	(120,493)
	-----	-----	-----
FINANCING ACTIVITIES			
Sale of common stock, net.....	4,371	11,976	7,017
Sale of convertible subordinated notes.....	--	--	103,500
Debt issuance costs.....	--	--	(3,370)
Net borrowings (repayments) of notes payable.....	(10,000)	10,000	(2,000)
Net borrowings (repayments) on equipment financing....	(5,646)	(854)	6,500
	-----	-----	-----
Net cash provided by (used for) financing activities...	(11,275)	21,122	111,647
	-----	-----	-----
Net increase (decrease) in cash and equivalents.....	(59,462)	(4,132)	25,327
CASH AND EQUIVALENTS AT BEGINNING OF PERIOD.....	90,484	94,616	69,289
	-----	-----	-----
CASH AND EQUIVALENTS AT END OF PERIOD.....	\$ 31,022	\$ 90,484	\$ 94,616
	=====	=====	=====
SUPPLEMENTAL CASH FLOW INFORMATION			
Interest paid.....	\$ 6,235	\$ 6,665	\$ 231
Income taxes paid (refunded), net.....	\$ (15,900)	\$ 10,119	\$ 20,483

</TABLE>

See accompanying notes to consolidated financial statements.

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### S3 INCORPORATED

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

##### 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

###### Organization

S3 Incorporated ("S3" or the "Company") was incorporated on January 9, 1989 and is a leading supplier of high performance multimedia accelerator solutions. The Company's products are used in, and its business is dependent on, the personal computer industry with sales primarily in the U.S., Asia and Europe (see Note 10). Its products are manufactured, assembled and tested by independent wafer foundries and contract manufacturers.

###### Basis of Presentation

The consolidated financial statements include the accounts of S3 Incorporated and its wholly-owned subsidiaries. All significant inter-company balances and transactions have been eliminated. Investments in entities in which the Company does not have control, but has the ability to exercise significant influence over operating and financial policies are accounted for by the equity method.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include allowances for doubtful accounts and customer returns, deferred tax assets, the useful lives of fixed assets and intangible assets, inventory reserves and other reserves. Actual results could differ from those estimates, and such differences may be material to the financial statements.

###### Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid investments with a remaining maturity of 90 days or less at the time of purchase to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value. The Company's short-term investments primarily comprise readily marketable debt and equity securities with remaining maturities of more than 90 days at the time of purchase.

The Company has classified its entire investment portfolio as available-for-sale. Available-for-sale securities are classified as cash equivalents or short-term investments and are stated at fair value with unrealized gains and losses included in accumulated other comprehensive income (loss). The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in interest income. Realized gains and losses are included in other income (expense). The cost of securities sold is based on the specific identification method.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents approximates fair value. The fair values of short-term investments, convertible subordinated notes and foreign currency forward exchange contracts are estimated based on quoted market prices.

Derivative Financial Instruments

The Company periodically enters forward foreign exchange contracts primarily to hedge the value of accounts receivable denominated in foreign currencies against fluctuations in exchange rates until such receivables are collected. The Company does not enter into forward foreign exchange contracts for speculative or trading purposes. The Company's accounting policies for these contracts are based on the Company's designation of the contracts as hedges of firm foreign currency commitments. Gains and losses on forward

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

foreign exchange contracts are deferred and recognized in income in the same period as losses and gains on the underlying transactions are recognized and generally offset. As of December 31, 1998, the Company had one foreign exchange forward contract outstanding. The Company purchased a forward contract allowing them to acquire approximately 1,500,000 Singapore Dollars for approximately \$879,000. The contract expires March 31, 1999.

Inventories

Inventories consist of work in process and finished goods and are stated at the lower of cost (first-in, first-out) or market. The Company's products typically experience short product life cycles and the Company estimates the market value of its inventory based on anticipated selling prices adjusted for completion and selling costs. Should the Company experience a substantial unanticipated decline in the selling price of its products and/or demand thereof, a material valuation adjustment and corresponding charge to operations could result.

Required payments under a wafer supply agreement to secure future production capacity are capitalized and amortized to inventory costs as the related product is received.

Inventories consist of:

<TABLE>  
<CAPTION>

	DECEMBER 31,	
	1998	1997
	(IN THOUSANDS)	
<S>	<C>	<C>
Work in process.....	\$ 6,340	\$28,392
Finished goods.....	5,043	43,490
Total.....	\$11,383	\$71,882

</TABLE>

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over estimated useful lives of three years for machinery and equipment and five years for furniture and fixtures. Leasehold

improvements are amortized using the straight-line method over the shorter of the lease term or the assets' useful lives.

Property and equipment consist of:

<TABLE>  
<CAPTION>

	DECEMBER 31,	
	1998	1997
	(IN THOUSANDS)	
<S>	<C>	<C>
Machinery and equipment.....	\$37,718	\$71,340
Furniture and fixtures.....	3,622	5,460
Leasehold improvements.....	4,347	3,688
	-----	-----
Total.....	45,687	80,488
Accumulated depreciation and amortization.....	(23,295)	(33,860)
	-----	-----
Property and equipment, net.....	\$22,392	\$46,628
	=====	=====

</TABLE>

#### Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 121 ("SFAS 121"), "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," the Company recognizes impairment losses on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets'

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

carrying amounts. The impairment loss is measured by comparing the fair value of the asset to its carrying amount. The Company annually evaluates the recoverability of its long-lived assets based on the estimated future undiscounted cash flows. See Note 12 for further discussion of impairment charges.

#### Foreign Currency Translation

The Company translates the accounts of its foreign subsidiaries using the local currency as the functional currency. Consequently, the assets and liabilities of the Company's subsidiaries and joint venture are translated into U.S. dollars at current exchange rates and revenues and expenses are translated at average monthly exchange rates. The resulting translation adjustments are recorded as a separate component of accumulated other comprehensive income (loss).

#### Revenue Recognition

Revenue from product sales made directly to customers is generally recognized upon shipment. Accruals for estimated sales returns and allowances are recorded at the time of sale. Certain of the Company's sales are made to distributors under agreements allowing price protection and rights of return on unsold products by the distributors. The Company defers recognition of revenue on such sales until the product is sold by the distributors.

#### Concentration of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, short-term investments, trade accounts receivable and foreign exchange contracts. The Company invests only in high credit quality short-term debt instruments and limits the amount of credit exposure to any one entity. A majority of the Company's trade receivables is derived from sales to manufacturers in the computer industry. Three customers accounted for greater than 75% of the Company's accounts receivable balance at December 31, 1998. The Company performs ongoing credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary but generally requires no collateral. The Company maintains reserves for potential credit losses, and all

such losses to date have been within management's expectations.

#### Research and Development Expenses

Research and development is expensed as incurred. To the extent research and development costs include the development of computer software, the Company believes that software development is an integral part of the semiconductor design and expenses all such costs as incurred.

#### Income Taxes

The Company accounts for income taxes using the asset and liability approach pursuant to SFAS No. 109, "Accounting for Income Taxes."

#### Stock-Based Compensation

The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." The Company adopted the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), which require the disclosure of pro forma net income and earnings per share as if the Company adopted the fair value-based method in measuring compensation expense as of the beginning of fiscal 1995.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

#### Recently Issued Accounting Standards

In June 1998, the Financial Accounting Standards Board issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") which provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. The statement is effective for fiscal years commencing after June 15, 1999. The Company does not believe that SFAS 133 will have a material impact on earnings or the financial condition of the Company.

#### Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation. Such reclassifications had no effect on net income (loss) or stockholders' equity.

## 2. FINANCIAL INSTRUMENTS

The following is a summary of available-for-sale securities:

<TABLE>

<CAPTION>

	AMORTIZED COST	MARKET VALUE	UNREALIZED HOLDING GAINS	UNREALIZED HOLDING LOSSES
	(IN THOUSANDS)			
<S>	<C>	<C>	<C>	<C>
DECEMBER 31, 1998:				
Corporate Debt Securities:				
Money market mutual funds.....	\$ 15,645	\$ 15,645	\$ --	\$ --
Commercial paper.....	5,475	5,470	--	(5)
Corporate bonds.....	35,802	35,860	68	(10)
Municipal bonds.....	5,000	5,000	--	--
Market auction preferreds.....	25,500	25,500	--	--
Certificates of deposit.....	19,002	19,016	16	(2)
	-----	-----	-----	-----
Total Corporate Debt Securities.....	106,424	106,491	84	(17)
	-----	-----	-----	-----
Corporate Equity Securities.....	6,600	4,204	--	(2,396)
	-----	-----	-----	-----
	\$113,024	\$110,695	\$ 84	\$ (2413)
	=====	=====	=====	=====
Included in short-term investments.....	\$ 90,881	\$ 88,553	\$ 84	\$ (2,412)
Included in cash and cash equivalents.....	22,143	22,142	--	(1)
	-----	-----	-----	-----
	\$113,024	\$110,695	\$ 84	\$ (2,413)

	=====	=====	=====	=====
DECEMBER 31, 1997:				
Corporate Debt Securities.....	\$ 21,931	\$ 21,954	\$ 42	\$ (19)
Mortgage-Backed Securities.....	3,197	3,197	--	--
Debt securities of states of the United States and political subdivisions of the states....	2,038	2,035	--	(3)
	-----	-----	-----	-----
Total short-term investments.....	27,166	27,186	42	(22)
	-----	-----	-----	-----
Corporate Equity Securities.....	5,000	8,646	3,646	--
	-----	-----	-----	-----
Total short-term and long-term investments.....	\$ 32,166	\$ 35,832	\$3,688	\$ (22)
	=====	=====	=====	=====

</TABLE>

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S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

Fair Value Disclosures

The carrying values and fair values of the Company's financial instruments are as follows:

<TABLE>

<CAPTION>

	DECEMBER 31, 1998		DECEMBER 31, 1997	
	CARRYING AMOUNT	ESTIMATED FAIR VALUE	CARRYING AMOUNT	ESTIMATED FAIR VALUE
	-----	-----	-----	-----
	(IN THOUSANDS)			
<S>	<C>	<C>	<C>	<C>
Cash and cash equivalents.....	\$ 31,022	\$31,022	\$ 90,484	\$90,484
Short-term investments.....	88,553	88,553	27,186	27,186
Convertible subordinated notes.....	(103,500)	(76,750)	(103,500)	(68,880)
Foreign currency forward exchange contracts.....	--	25	--	--

</TABLE>

3. INVESTMENTS

Investment in USC

During 1995, the Company entered into two long-term manufacturing capacity arrangements. The Company entered into an agreement with United Microelectronics Corporation (UMC) and Alliance Semiconductor Corporation to form United Semiconductor Corporation ("USC"), a separate Taiwanese company, for the purpose of building and managing a semiconductor manufacturing facility in the Science Based Industrial Park in Hsin Chu City, Taiwan, Republic of China. The Company invested \$36.4 million in 1995 and \$53.0 million in 1996 for its 23.75% equity interest. On December 31, 1997, the Company entered into an agreement with UMC to sell to UMC 80 million shares of stock of USC for a purchase price of 2.4 billion New Taiwan dollars. The Company received the purchase price (approximately \$68.0 million in cash) in January 1998 upon closing. As a result of the January 1998 sale to UMC, S3's percentage ownership in USC decreased to 15.75%. The facility commenced production utilizing advanced submicron semiconductor manufacturing processes in 1996. The Company has the right to purchase up to 31.25% of the output from the foundry.

The Company accounts for its investment in USC using the equity method of accounting. The Company records its share of the earnings or losses of the investment in its income statement. The Company believes that the equity method of accounting is appropriate due to the significant influence it has in the financial and operating decisions of USC.

Summarized financial information below uses the respective year-end exchange rate for the financial position and an average exchange rate for the respective year for results of operations. Summarized financial information of USC at December 31, 1998, 1997 and 1996 is as follows (in thousands):

<TABLE>

<CAPTION>

YEAR ENDED DECEMBER 31,

	1998	1997	1996
<S>	<C>	<C>	<C>
RESULTS OF OPERATIONS			
Net sales.....	U.S. \$352,827	U.S. \$328,966	U.S. \$60,656
Gross profit.....	152,566	151,037	16,941
Net income.....	112,151	136,969	577

</TABLE>

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S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

<TABLE>  
<CAPTION>

	DECEMBER 31,	
	1998	1997
<S>	<C>	<C>
FINANCIAL POSITION		
Current Assets.....	U.S. \$398,284	U.S. \$349,419
Non-current Assets.....	526,175	370,394
Current Liabilities.....	151,418	127,873
Non-current Liabilities.....	219,697	159,644
Stockholders' Equity.....	553,344	432,296

</TABLE>

Interest in Partnership

In 1995, the Company entered into a limited partnership arrangement with a developer to obtain a ground lease and develop and operate the Company's current Santa Clara facilities. The Company's investment of \$2.1 million represents a 50% interest in Mission Real Estate L.P. (the partnership), in which the Company is a limited partner. Permanent nonrecourse financing has been obtained. The Company is not a guarantor on the permanent financing.

4. CONVERTIBLE SUBORDINATED NOTES

In September 1996, the Company completed a private placement of \$103.5 million aggregate principal amount of convertible subordinated notes. The notes mature in 2003. Interest is payable semi-annually at 5 3/4% per annum. The notes are convertible at the option of the note holders into the Company's common stock at an initial conversion price of \$19.22 per share, subject to adjustment. Beginning in October 1999, the notes are redeemable at the option of the Company at an initial redemption price of 102% of the principal amount. The Company has reserved 5,385,015 shares of common stock (plus such additional number of shares that may be required pursuant to the operation of anti-dilution provisions) for the conversion of these notes. Offering costs of approximately \$3.4 million are included in other assets and are amortized on a straight-line basis over the term of the notes. The fair value of the convertible subordinated notes at December 31, 1998 was approximately \$76.75 million.

5. LINE OF CREDIT AND NOTES PAYABLE

As of December 31, 1997, the Company had \$10.0 million outstanding under a \$75.0 million unsecured revolving line of credit that expired September 26, 1998. Borrowings were charged interest at the bank's prime rate. The Company was not in compliance with one financial covenant at December 31, 1997. Subsequent to year-end, the lender waived non-compliance with the violated debt covenant for the period ended December 31, 1997. During 1998, the Company repaid all amounts outstanding and terminated this unsecured revolving line of credit.

The Company had two separate secured equipment lines of credit totaling \$10.0 million at December 31, 1997. Borrowings were charged interest at the prime rate. The Company had \$5.6 million outstanding under these secured equipment lines at December 31, 1997. During 1998, the Company repaid all amounts outstanding and terminated these two secured equipment lines of credit.

In 1995 the Company expanded and formalized its relationship with Taiwan Semiconductor Manufacturing Company (TSMC) to provide additional capacity over the 1996 to 2000 timeframe. The agreement with TSMC requires the Company to make certain annual advance payments to be applied against the following year's capacity. The Company has signed promissory notes to secure these payments over

the term of the agreement. The notes bear interest at 10% per annum commencing on the individual notes' maturity dates if such notes are not paid. The Company made no payments in 1998, and paid \$9.6 million in 1997 and

S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

\$7.2 million in 1996. At December 31, 1998, the remaining advance payments (and corresponding promissory notes) totaled \$14.4 million which the Company is obligated to pay in 1999. During 1998, the Company commenced negotiations with TSMC to modify and amend its capacity agreement. Although the terms have not been finalized, the Company is requesting TSMC to reduce its option capacity and extend the term of the agreement.

6. STOCKHOLDERS' EQUITY

Preferred Stock

The number of shares of preferred stock authorized to be issued is 5,000,000 with a par of \$0.0001 per share. The preferred stock may be issued from time to time in one or more series. The Board of Directors is authorized to provide rights, preferences, privileges and restrictions of the shares of such series. As of December 31, 1998, no shares of preferred stock had been issued.

Stockholder Rights Plan

On May 14, 1997, the Board adopted a Stockholder Rights Plan. To implement the plan, S3's Board declared a dividend of one preferred stock purchase right (a "Right") for each outstanding share of S3 common stock held of record on June 1, 1997. Each Right represents a contingent right to purchase, under certain circumstances, a fractional share of a newly created series of S3 preferred stock. The Rights would become exercisable and trade independently from S3 common stock upon the public announcement of the acquisition by a person or group of 15 percent or more of S3's common stock, or ten days after commencement of a tender or exchange offer for S3 common stock that would result in the acquisition of 15 percent or more of S3's common stock. In the event one of the limited conditions is triggered, each Right entitles the registered holder to purchase one one-thousandth of a share of Preferred Stock at an exercise price of \$85.00 per right. The Rights may be redeemed at \$0.01 per Right pursuant to the plan by the Board of Directors. The Rights expire May 14, 2007.

Employee Stock Purchase Plan

Under the Company's 1993 Employee Stock Purchase Plan (the "Purchase Plan") 2,800,000 shares of common stock are reserved for issuance pursuant thereto. The Purchase Plan permits eligible employees to purchase shares at a price equal to 85% of the lower of the fair market value at the beginning or end of the offering period. At December 31, 1998, 1,618,169 shares have been issued under the Purchase Plan and 1,181,831 shares have been reserved for further issuance.

Stock Plan

Under the Company's stock option plan (the "Option Plan") at December 31, 1998, 26,253,692 shares of common stock have been authorized for the grant of incentive or nonstatutory stock options and the direct award or sale of shares to employees, directors and consultants. Incentive stock options must be granted at not less than fair market value at the date of grant. The exercise price of nonstatutory options and the share price for shares sold generally may be no less than 85% of fair market value at the date of the grant or sale. At December 31, 1998, 16,562,258 shares of common stock are reserved for issuance under the Option Plan and 1,547,576 shares were available for future grant.

S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

A summary of stock option activity is as follows:

<TABLE>  
<CAPTION>

<u>&lt;S&gt;</u>	<u>NUMBER OF SHARES</u>	<u>WEIGHTED AVERAGE PRICE PER SHARE</u>
<u>&lt;C&gt;</u>	<u>&lt;C&gt;</u>	<u>&lt;C&gt;</u>
BALANCE, JANUARY 1, 1996.....	6,984,939	\$ 8.37
Options granted.....	6,538,362	12.09
Options exercised.....	(1,204,235)	3.83
Options cancelled.....	(3,398,967)	15.28
-----		
BALANCE, DECEMBER 31, 1996.....	8,920,099	9.06
Options granted.....	11,950,388	7.77
Options exercised.....	(1,703,768)	5.16
Options cancelled.....	(9,114,879)	11.17
-----		
BALANCE, DECEMBER 31, 1997.....	10,051,840	6.28
Options granted.....	9,609,391	4.26
Options exercised.....	(560,546)	3.57
Options cancelled.....	(4,057,968)	7.09
-----		
BALANCE, DECEMBER 31, 1998.....	15,042,717	4.86
=====		

</TABLE>

Options to purchase 4,400,697, 2,284,502 and 2,267,969 shares were exercisable at December 31, 1998, 1997 and 1996, respectively, with a weighted average exercise price of \$5.89, \$7.16 and \$4.29, respectively. Options to purchase 4,500,000 shares granted in October 1998 to Kenneth F. Potashner were granted outside of the plan.

Options generally vest over a period of four years and generally become exercisable beginning either six months or one year from the date of employment or grant. Options generally expire ten years from the date of grant. The Company repriced options on 6,520,033 shares to \$5.125, the fair market value on December 18, 1997. The repriced options are treated as cancelled and regranted, however, they retained their original vesting terms and expiration dates. All replacement options were subject to a one-year blackout on exercise (with the exception of those options held by employees whose employment was terminated on January 20, 1998 as part of a reduction in force announced by the Company). With regard to other employees whose employment was not terminated on January 20, 1998, if their employment was terminated prior to the end of the blackout period, any repriced options were forfeited.

In October 1998, the Company entered into an employment agreement with Kenneth F. Potashner, pursuant to which Mr. Potashner is employed as the President, Chief Executive Officer and Chairman of the Board. Mr. Potashner received two options to purchase an aggregate of 4,500,000 shares of the Common Stock of the Company. One option for 1,500,000 shares vests upon the earlier of (i) six months from the date Mr. Potashner was hired by the Company, (ii) a change in control of the Company, (iii) the termination of Mr. Potashner's employment without cause or (iv) the termination of Mr. Potashner's employment following the occurrence of among other things, a diminution in Mr. Potashner's duties or a reduction in Mr. Potashner's compensation, each of which is deemed a "constructive termination" and treated similarly to a termination without cause. The second option for 3,000,000 shares vests over a four year period in accordance with the following schedule: 750,000 shares shall vest on the first anniversary of Mr. Potashner's employment with the Company; thereafter, the options shall vest in equal monthly installments of 62,500 shares.

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S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

Stock Compensation Arrangement

Pursuant to an incentive compensation plan for certain employees, the Company issued 99,071 shares of common stock on June 30, 1997 and on June 30, 1996. No shares were issued under this plan during 1998. The Company accrued the related compensation cost ratably over the periods.

Stock-Based Compensation

Under APB 25, the Company generally recognizes no compensation expense with respect to stock-based awards to employees. Pro forma information regarding net income (loss) and net income (loss) per share is required by SFAS 123 for awards granted after December 31, 1994, as if the Company had accounted for its

stock-based awards to employees under the fair value method of SFAS 123. The fair value method of the Company's stock-based awards to employees was estimated using the Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating fair value of traded options that have no vesting restrictions and are fully transferable. The Black-Scholes model requires the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock-based awards to employees have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock-based awards to employees.

The following table summarizes significant ranges of outstanding and exercisable options at December 31, 1998:

<TABLE>  
<CAPTION>

		OPTIONS OUTSTANDING		OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (YRS)	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
<S>	<C>	<C>	<C>	<C>	<C>
\$ 0.12 - \$ 4.88	7,125,131	7.89	\$3.51	717,886	\$3.43
4.91 - 8.63	7,103,676	8.36	5.40	3,119,888	5.37
10.00 - 14.50	738,187	7.52	11.45	509,021	11.30
16.13 - 20.19	75,723	7.66	17.20	53,902	17.37
	-----			-----	
\$ 0.12 - \$20.19	15,042,717	8.09	\$4.86	4,400,697	\$5.89
	=====			=====	

</TABLE>

The fair value of the Company's stock-based awards to employees was estimated assuming no expected dividends and the following weighted-average assumptions:

<TABLE>  
<CAPTION>

	STOCK OPTION PLAN			EMPLOYEE STOCK PURCHASE PLAN		
	1998	1997	1996	1998	1997	1996
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Expected life from vest date	0.5 yrs.....	0.5 yrs.	0.5 yrs.	0.0 yrs.	0.0 yrs.	0.0 yrs.
Volatility.....	84%	69%	60%	84%	65%	60%
Risk-free interest rate.....	4.9%	5.9%	6.1%	5.0%	5.5%	6.1%

</TABLE>

The weighted-average estimated fair value of stock options granted during 1998, 1997 and 1996 was \$2.21, \$3.53 and \$4.97 per share, respectively. The weighted-average estimated fair value of shares granted under the Purchase Plan during 1998, 1997 and 1996 was \$3.46, \$5.17 and \$6.97 per share, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

For pro forma purposes, the estimated fair value of the Company's stock-based awards to employees is generally amortized over the vesting period of four years (for options) and the offering period (for stock purchases under the Purchase Plan). The Company's pro forma information is as follows:

<TABLE>  
<CAPTION>

		YEAR ENDED DECEMBER 31,		
		1998	1997	1996
<S>	<C>	<C>	<C>	<C>
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)				

Pro forma net income (loss).....	\$ (127,967)	\$ (7,575)	\$28,504
Pro forma per share amounts:			
Basic.....	\$ (2.51)	\$ (0.15)	\$ 0.60
Diluted.....	\$ (2.51)	\$ (0.15)	\$ 0.56

Because SFAS 123 is applicable only to awards granted subsequent to December 31, 1994, its pro forma effect will not be fully reflected until approximately 1999.

#### Intel Warrant

In December 1998, the Company entered into an agreement pursuant to which it agreed to issue to Intel Corporation a warrant to purchase 1,000,000 shares of the Company's Common Stock at an exercise price of \$9.00 per share. The purchase price for the warrant was \$990,000. The warrant expires in December 2000.

### 7. LEASES AND COMMITMENTS

#### Operating Leases

The Company leases administrative facilities under operating leases that expire in 2008. During 1995, the Company entered into a limited partnership arrangement with a developer to obtain a ground lease and develop and operate the Company's Santa Clara, California facilities. In January 1997, prior to the expiration of the lease terms of the previous facilities, the Company relocated its principal administrative facilities to the new Santa Clara facilities at which time the Company's minimum operating lease payment of \$369,000 commenced for the initial 12 year term. During 1997, the Company sublet a portion of its previous facilities for the remaining lease terms and negotiated a lease termination on the other two previous facilities. During 1998, the Company sublet a portion of its current facilities through 2008.

Future minimum annual payments under operating leases are as follows:

<TABLE>	
<CAPTION>	
	OPERATING LEASES
	-----
	(IN THOUSANDS)
<S>	<C>
1999.....	\$ 8,571
2000.....	6,756
2001.....	5,186
2002.....	4,426
2003.....	4,426
Thereafter.....	22,129
	-----
Total minimum lease payments.....	\$51,494
	=====

</TABLE>

The total of minimal rentals to be received in the future under non-cancelable subleases is \$45.1 million as of December 31, 1998.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

Rent expense for 1998, 1997 and 1996, was \$8.9 million, \$7.1 million and \$3.5 million, respectively. Sublease income for 1998, 1997 and 1996 was \$2.6 million, \$1.5 million and \$0, respectively. Net rent expense for 1998, 1997 and 1996 was \$6.3 million, \$5.6 million and \$3.5 million, respectively.

### 8. INCOME TAXES

The provision for income taxes consists of:

<TABLE>	
<CAPTION>	
	YEARS ENDED DECEMBER 31,
	-----
	1998            1997            1996

	(IN THOUSANDS)		
<S>	<C>	<C>	<C>
<b>CURRENT TAX EXPENSE:</b>			
Federal.....	\$ (20,802)	\$ (6,102)	\$27,838
State.....	--	4,123	3,966
	(20,802)	(1,979)	31,804
<b>DEFERRED TAX EXPENSE:</b>			
Federal.....	4,995	(3,248)	(10,722)
State.....	3,851	(3,270)	(1,290)
	8,846	(6,518)	(12,012)
Total.....	\$ (11,956)	\$ 8,497	\$19,792

</TABLE>

The tax benefits resulting from disqualifying dispositions of shares acquired under the Company's incentive stock option plan and from the exercise of non-qualified stock options reduced taxes currently payable as shown by \$3,825,000 in 1997 which is reflected as additional paid-in capital. There was no tax benefit in 1998 associated with stock option activity.

The difference between the provision for taxes on income and the amount computed by applying the federal statutory income tax rate to income before taxes is explained below:

<TABLE>  
<CAPTION>

	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
	(IN THOUSANDS)		
<S>	<C>	<C>	<C>
Tax computed at 35%.....	\$ (49,920)	\$ (6,521)	\$20,623
State income taxes, net of federal effect....	--	554	1,739
Tax credits.....	(2,800)	(2,200)	(3,396)
Valuation allowance for tax losses and credits.....	40,729	--	--
Other.....	35	(330)	826
Provision for income taxes.....	\$ (11,956)	\$ (8,497)	\$19,792
Effective tax rate.....	8.4%	45.6%	33.6%

</TABLE>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

Significant components of the Company's deferred income tax asset are as follows:

<TABLE>  
<CAPTION>

	DECEMBER 31,	
	1998	1997
	(IN THOUSANDS)	
<S>	<C>	<C>
<b>Deferred tax assets:</b>		
Reserves not currently deductible.....	\$10,682	\$ 5,138
Deferred revenue.....	--	4,214
Compensation expense not currently deductible.....	4,185	3,762
Depreciation/Amortization.....	16,851	4,021
Credits and net operating loss carryforwards.....	16,653	5,307
Total deferred tax assets.....	48,371	22,442
Valuation allowance for deferred tax assets.....	(40,729)	--

Net deferred tax assets.....	7,642	22,442
	-----	-----
Deferred tax liabilities:		
Earnings from foreign joint venture.....	(7,642)	(13,573)
Other.....	--	(23)
	-----	-----
Total deferred tax liabilities.....	(7,642)	(13,596)
	-----	-----
Net deferred tax asset.....	\$ --	\$ 8,846
	=====	=====

</TABLE>

The Company has net operating loss carryforwards for federal and state tax purposes of approximately \$16.0 million and \$25.0 million, respectively, expiring in 2002 through 2018. The Company has tax credit carry-forwards for federal and state purposes of approximately \$6.4 million and \$5.0 million, respectively, most of which will expire between 2005 and 2018.

#### 9. EMPLOYEE BENEFIT PLANS

The Company implemented a non-qualified cash profit sharing plan in 1994 under which all employees of the Company, including officers are eligible to receive, on an annual basis, an equal cash bonus based on pretax profits, prorated for service with the Company. The cash bonus under this plan was \$0, \$0, and \$2.0 million in 1998, 1997 and 1996, respectively.

As part of his employment agreement, the President and CEO of the Company is eligible for a one-time "special cash bonus" on the third anniversary of the date of his employment in the event that the Company's Common Stock has not achieved a \$4.67 per share increase in value as determined from the date of the President and CEO's date of employment. The one-time special cash bonus, if payable, will be equal to \$7,000,000 less an amount which adjusts for any increase in the share price of the Company's Common Stock above the exercise price per share of the 1,500,000 Share Option granted to the President and CEO pursuant to his employment agreement with the Company. The one-time special cash bonus may also be payable in the event the President and CEO's employment is terminated without cause. If employment is terminated without cause, the one-time special cash bonus will be calculated and paid as of the date of the termination. The Company will continue to pay the President and CEO his maximum bonus for twelve months following his termination. During such twelve-month period, the vesting on the 3,000,000 Share Option will continue (See Note 6). If termination without cause occurs following a change in control of the Company, the twelve-month period for compensation and benefit continuation will be extended to eighteen months, and Mr. Potashner will receive an additional cash payment to the extent that the sum of his continued compensation, special cash payment and the net exercise value of the 3,000,000 Share Option does not exceed \$10,000,000.

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#### S3 INCORPORATED

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

In November 1998, the Company instituted a bonus plan for certain key individuals that provides for cash payments of \$3.0 million and a contingent payment of \$8.0 million upon the initial public offering of its investment in USC. These payments will be paid out if the individuals meet certain employment milestones.

The Company has a 401(k) tax-deferred savings plan whereby all employees meeting certain age and service requirements may contribute up to 20% of their eligible compensation (up to a maximum allowed under IRS rules). Contributions may be made by the Company at the discretion of the Board of Directors. No contributions by the Company have been made to the plan since its inception.

#### 10. EXPORT SALES AND SIGNIFICANT CUSTOMERS

The Company's primary operations are located in the United States. The Company sells its products into the personal computer market primarily in the U.S., Asia and Europe. Export sales accounted for 89%, 70% and 58% of net sales in 1998, 1997 and 1996, respectively. Approximately 29%, 28% and 37% of export sales in 1998, 1997 and 1996, respectively, were to affiliates of United States customers. In 1998, 18% and 55% of export sales were shipped to Hong Kong and Taiwan, respectively. In 1997, 14% and 53% of export sales were shipped to Hong Kong and Taiwan, respectively. In 1996, 16% and 45% of export sales were shipped to Hong Kong and Taiwan, respectively. Three customers accounted for 39%, 14%

and 13%, respectively, of net sales in 1998. Three customers accounted for 20%, 13% and 12%, respectively, of net sales in 1997. Two customers accounted for 16% and 15% respectively, of net sales in 1996.

In June 1997, SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information" was issued and adopted by the Company in 1998. SFAS 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to stockholders. It also establishes standards for related disclosures about products and services, geographic areas and major customers. The Company operates and tracks its results in one segment. The Company's chief operating decision maker believes that management decisions regarding products, geographic areas and customers can be made with Company wide data at the current time. Accordingly, there are no additional disclosure requirements involved with the Company's adoption of SFAS 131.

11. CONTINGENCIES

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. The Company is party to various claims of this nature. Although the ultimate outcome of these matters is not presently determinable, management believes that the resolution of all such pending matters will not have a material adverse effect on the Company's financial position or results of operations.

Since November 1997, a number of complaints have been filed in federal and state courts seeking an unspecified amount of damages on behalf of an alleged class of persons who purchased shares of the Company's common stock at various times between April 18, 1996 and November 3, 1997. The complaints name as defendants the Company, certain of its officers and former officers, and certain directors of the Company, asserting that they violated federal and state securities laws by misrepresenting and failing to disclose certain information about the Company's business. In addition, certain stockholders have filed derivative actions in the state courts of California and Delaware seeking recovery on behalf of the Company, alleging, among other things, breach of fiduciary duties by such individual defendants. The derivative cases in California state court have been consolidated, and plaintiffs have filed a consolidated amended complaint. The court has entered a stipulated order in those derivative cases suspending court proceedings and coordinating discovery in them with discovery in the class actions in California state courts. On plaintiffs' motion, the federal court has dismissed the federal class actions without prejudice. The class actions in California state court have been consolidated, and plaintiffs have filed a consolidated amended complaint. The Company has

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

answered that complaint. Discovery is pending. While management intends to defend the actions against the Company vigorously, there can be no assurance that an adverse result or settlement with regards to these lawsuits would not have a material adverse effect on the Company's financial condition or results of operations.

The Company has received from the United States Securities and Exchange Commission a request for information relating to the Company's restatement announcement in November 1997. The Company has responded and intends to continue to respond to such requests.

12. OTHER OPERATING EXPENSES

Other operating expense is as follows:

<TABLE>  
<CAPTION>

	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
	(IN THOUSANDS)		
<S>	<C>	<C>	<C>
Write-off of acquired technologies.....	\$ 8,000	\$ --	\$ --
Impairment of long-lived assets.....	27,226	17,180	--
Restructuring.....	6,109	--	--

Total.....	----- \$41,335 =====	----- \$17,180 =====	----- \$ -- =====
------------	----------------------------	----------------------------	-------------------------

</TABLE>

In January 1998, the Company entered into a \$40.0 million technology exchange with Cirrus Logic, Inc. to obtain graphic functionality technologies. As a result of the exchange, the Company acquired the technology covered by 10 graphic patents and 25 graphic patent applications, as well as cross-licensed Cirrus Logic's remaining patents. Under the terms of the cross-licensing provisions, the Company and Cirrus Logic have a perpetual license to each other's graphic patents and additional licenses with respect to the other party's patents for agreed upon periods of time. The Company wrote-off \$8.0 million of the value of the acquired technologies that were not realizable based on estimated cash flows from the sale of products currently sold by the Company. The remaining \$32.0 million intangible asset was being amortized to cost of sales based on the estimated lives of the currently utilized core technologies, which was generally five years until the fourth quarter of 1998.

During the fourth quarter of 1998, management reevaluated the carrying value of the intangible assets recorded in connection with the technology exchange with Cirrus Logic, Inc., and related to the patents obtained from Brooktree, as well as other long-lived assets, including property and equipment. This revaluation was necessitated by management's determination based on recent results of operations and that the future expected sales and cash flows for the Company's operations would be substantially lower than had been previously expected by management. Expected undiscounted future cash flows were not sufficient to recover the carrying value of such assets. Accordingly, an impairment loss of \$27.2 million, representing the excess of the carrying value over the estimated fair value of the assets, was recognized for write-downs of a substantial portion of the intangible assets. The estimated fair value of the intangible assets was based on management's best estimate of the patent portfolio based on a comparison to other graphics technology portfolios in the marketplace. The Company determined that no write-down of property and equipment was necessary at December 31, 1998 based on its estimate of the fair value of such assets. Due to technological changes in the graphics marketplace, the Company concluded it should accelerate its amortization of its remaining patent portfolio, of approximately \$4.0 million, over the current estimated life of the currently utilized core technologies, which is two years.

In July 1998, the Company implemented a restructuring plan in order to align resources with a new business model and to lower the Company's overall cost structure. In connection with the restructuring, the

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

Company reduced its headcount and consolidated facilities. The following analysis sets forth the significant components of the restructuring reserve at December 31, 1998:

<TABLE>

<CAPTION>

	SEVERANCE AND BENEFITS	FACILITY CLOSURE	FURNITURE AND EQUIPMENT	TOTAL
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
Restructuring charge.....	\$1,024	\$ 2,474	\$ 2,611	\$ 6,109
Cash charge.....	(804)	--	--	(804)
Non-cash charge.....	--	(2,474)	(2,611)	(5,085)
	-----	-----	-----	-----
Reserve balance December 31, 1998.....	\$ 220	\$ --	\$ --	\$ 220
	=====	=====	=====	=====

</TABLE>

Severance and related benefits represented the reduction of approximately 70 employees, of which 69 have been paid and separated from the Company as of December 31, 1998. All severance packages will be paid by the end of the second quarter of 1999. The number of temporary employees and contractors used by the Company was also reduced. The restructuring expense included the write-off or write-down in carrying value of equipment, which consists primarily of workstations, personal computers and furniture that will no longer be utilized in the Company's operations. These assets were written down to their estimated

fair value less cost to sell. Facility closure expenses were incurred as a result of the Company's plan to vacate one of two leased buildings at the Company's headquarters facility, and include leasehold improvements, furniture, fixtures and network costs. The Company plans to complete its move by the end of the second quarter of 1999.

During the fourth quarter of 1997, the Company wrote-off approximately \$17.2 million of intangible assets including certain license, patents and other technology, as a result of management's decision to focus attention on the core graphics business. As a result of this decision, no future cash flows were expected related to these assets.

### 13. EARNINGS PER SHARE

When computing diluted earnings per share, the Company includes only potential common shares that are dilutive. Exercise of approximately 15,042,000 options in 1998 and the conversion of approximately 5,385,000 convertible securities in 1998 and 1997 is not assumed because the result would have been anti-dilutive.

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### S3 INCORPORATED

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

The following table sets forth the computation of basic and diluted earnings per share:

<TABLE>  
<CAPTION>

	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
	-----		
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)		
<S>	<C>	<C>	<C>
NUMERATOR			
Net Income (Loss)			
Basic.....	\$ (113,204)	\$ 8,878	\$ 41,588
Interest expense on subordinated debt...	--	--	1,071
	-----	-----	-----
Diluted.....	\$ (113,204)	\$ 8,878	\$ 42,659
	=====	=====	=====
DENOMINATOR			
Denominator for basic earnings per share...	51,078	49,519	47,460
Common stock equivalents.....	--	2,221	3,469
Subordinated debt.....	--	0	1,522
	-----	-----	-----
Denominator for diluted earnings per share.....	51,078	51,740	52,451
	=====	=====	=====
Basic earnings per share.....	\$ (2.22)	\$ 0.18	\$ 0.88
Diluted earnings per share.....	\$ (2.22)	\$ 0.17	\$ 0.81

</TABLE>

### 14. COMPREHENSIVE INCOME

As of January 1, 1998, the Company adopted SFAS No. 130, "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 establishes new rules for the reporting and display of comprehensive income and its components; however, the adoption of the Statement had no impact on the Company's net income (loss) or stockholders' equity. SFAS 130 requires unrealized gains or losses on the Company's available-for-sale securities and foreign currency translation adjustments, which prior to adoption were reported separately in stockholders' equity, to be included in other comprehensive income. Prior year financial statements have been reclassified to conform to the requirements of SFAS 130.

The following are the components of accumulated other comprehensive loss, net of tax:

<TABLE>  
<CAPTION>

	DECEMBER 31,		
	1998	1997	1996
	-----		

	(IN THOUSANDS)		
<S>	<C>	<C>	<C>
Unrealized gain (loss) on investments.....	\$ (2,329)	\$ 3,666	\$ (54)
Foreign currency translation adjustments.....	(12,426)	(19,944)	--
Accumulated other comprehensive loss.....	\$ (14,755)	\$ (16,278)	\$ (54)

</TABLE>

The following schedule of other comprehensive income (loss) shows the gross current-period gain (loss) and the reclassification adjustment. Due to the Company's 1998 and 1997 operating losses and the immaterial components of other comprehensive income in 1996, tax amounts were nominal.

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S3 INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
YEARS ENDED DECEMBER 31, 1998, 1997, AND 1996

<TABLE>  
<CAPTION>

	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
	(IN THOUSANDS)		
<S>	<C>	<C>	<C>
Unrealized gain (loss) on investments			
Unrealized gain (loss) on available-for-sale securities.....	\$ (5,967)	\$ 3,715	\$ (92)
Less: reclassification adjustment for (gain) loss realized in net income.....	(28)	5	24
Net unrealized gain (loss) on investments.....	(5,995)	3,720	(68)
Foreign currency translation adjustments.....	7,518	(19,944)	--
Other comprehensive income (loss).....	\$ 1,523	\$ (16,224)	\$ (68)

</TABLE>

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SELECTED QUARTERLY CONSOLIDATED FINANCIAL DATA (UNAUDITED) (1)

<TABLE>  
<CAPTION>

	FOURTH QUARTER	THIRD QUARTER	SECOND QUARTER	FIRST QUARTER
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)			
<S>	<C>	<C>	<C>	<C>
YEAR ENDED DECEMBER 31, 1998				
Net sales.....	\$ 41,547	\$ 47,286	\$ 53,299	\$ 82,507
Gross margin (loss).....	(16,322)	(7,920)	6,492	15,678
Income (loss) from operations(2).....	(70,760)	(43,805)	(22,485)	(26,849)
Net income (loss) (3).....	\$ (70,290)	\$ (35,401)	\$ (11,634)	\$ 4,121
Per share amounts:				
Basic.....	\$ (1.36)	\$ (0.69)	\$ (0.23)	\$ 0.08
Diluted(4).....	\$ (1.36)	\$ (0.69)	\$ (0.23)	\$ 0.08
Shares used in computing per share amounts:				
Basic.....	51,554	51,174	50,985	50,601
Diluted(4).....	51,554	51,174	50,985	52,148
Stock prices: (5)				
High.....	\$ 8.25	\$ 5.38	\$ 7.97	\$ 7.88
Low.....	\$ 2.00	\$ 2.81	\$ 5.00	\$ 4.94
YEAR ENDED DECEMBER 31, 1997				
Net sales.....	\$101,911	\$119,604	\$ 84,589	\$130,255
Gross margin.....	26,443	33,413	24,883	50,435
Income (loss) from operations(2).....	(25,305)	(407)	(9,648)	18,863
Net income (loss).....	\$ (8,122)	\$ 4,384	\$ (1,766)	\$ 14,382
Per share amounts:				
Basic.....	\$ (0.16)	\$ 0.09	\$ (0.04)	\$ 0.30
Diluted(4).....	\$ (0.16)	\$ 0.08	\$ (0.04)	\$ 0.27

Shares used in computing per share amounts:				
Basic.....	50,440	49,764	49,201	48,672
Diluted(4).....	50,440	52,380	49,201	57,503
Stock prices:(5)				
High.....	\$ 13.19	\$ 17.44	\$ 13.13	\$ 18.88
Low.....	\$ 4.81	\$ 10.56	\$ 9.19	\$ 12.44

</TABLE>

- 
- (1) The preceding table presents selected unaudited consolidated financial results for each of the eight quarters in the two-year period ended December 31, 1998. In the Company's opinion, this unaudited information has been prepared on the same basis as the audited information and includes all adjustments (consisting of only normal recurring adjustments) necessary for a fair statement of the financial information for the period presented.
  - (2) Loss from operations for 1998 includes a write-off of acquired technologies of \$8.0 million in the first quarter of 1998, a charge for impairment of long-lived assets of \$27.2 million in the fourth quarter of 1998 and a restructuring charge of \$6.1 million in the third quarter of 1998. Income (loss) from operations for 1997 includes a charge for impairment of long-lived assets of \$17.2 million in the fourth quarter of 1997.
  - (3) Net income (loss) includes gain on sale of joint venture of \$26.6 million in the first quarter of 1998.
  - (4) Diluted earnings per share includes the effect of incremental shares issuable upon the conversion of the convertible subordinated notes, the dilutive effect of outstanding options and an adjustment to net income for the interest expense (net of income taxes) related to the notes unless the impact of such conversion is anti-dilutive. The effect of the conversion was anti-dilutive in the second and fourth quarters of 1997 and all quarters of 1998.
  - (5) The Company's common stock trades on the Nasdaq National Market under the symbol SIII. The table indicates the range of the high and low closing prices, as reported by Nasdaq.

At December 31, 1998, there were approximately 665 stockholders of record of the Company's common stock and approximately 35,000 beneficial stockholders. The Company has never declared or paid cash dividends on its capital stock and does not anticipate paying any cash dividends in the foreseeable future. The Company currently intends to retain future earnings for the development of its business.

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UNITED SEMICONDUCTOR CORPORATION

FINANCIAL STATEMENTS

DECEMBER 31, 1998 AND 1997

53

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January 22, 1999  
(99)B.L36P4065

To the Board of Directors of United Semiconductor Corporation

We have examined the accompanying balance sheets of United Semiconductor Corporation as of December 31, 1998 and 1997, and the related statements of income, of changes in stockholders' equity and of cash flows for the years then ended. Our examinations were made in accordance with the "Rules Governing the Certification of Financial Statements by Certified Public Accountants" and generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements examined by us present fairly the financial position of United Semiconductor Corporation as of December 31, 1998 and 1997, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles consistently applied.

UNITED SEMICONDUCTOR CORPORATION  
BALANCE SHEET  
DECEMBER 31,  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

ASSETS

<TABLE>  
<CAPTION>

	1998	1997
	-----	-----
<S>	<C>	<C>
CURRENT ASSETS		
Cash and cash equivalents (Note 4(1)).....	\$ 7,516,907	\$ 5,469,227
Marketable securities (Note 4(2)).....	3,138,393	3,190,746
Notes receivable		
-- third parties.....	189	--
-- related parties (Note 5).....	8,352	781
Accounts receivable		
-- third parties (Note 4(3)).....	778,399	937,320
-- related parties (Note 5).....	436,937	939,664
Other receivables.....	165,146	88,905
Inventories (Note 4(4)).....	665,344	511,486
Prepaid expenses.....	7,803	17,669
Other current assets (Note 4(12)).....	93,353	230,381
	-----	-----
	12,810,823	11,386,179
	-----	-----
LONG-TERM INVESTMENTS (NOTES 4(5))		
Long-term investment.....	105,759	--
Prepaid long-term investment.....	250,400	--
	-----	-----
	356,159	--
	-----	-----
PROPERTY, PLANT AND EQUIPMENT (NOTES 4(6) AND 6)		
Cost		
Machinery and equipment.....	18,591,271	10,169,495
Transportation equipment.....	3,206	3,206
Furniture and fixtures.....	217,742	130,771
Leasehold improvements.....	10,966	10,966
Other equipment.....	40,974	14,270
	-----	-----
	18,864,159	10,328,708
Accumulated depreciation.....	(4,452,290)	(1,944,961)
Construction in progress and prepayments.....	967,065	2,460,306
	-----	-----
	15,378,934	10,844,053
	-----	-----
INTANGIBLE ASSET		
Other intangible assets.....	813,455	1,037,500
	-----	-----
OTHER ASSETS		
Deposit-out.....	1,475	30,979
Deferred expense.....	134,044	54,027
Deferred income tax assets (Note 4 (12)).....	238,121	103,102
Other assets.....	2,231	--
	-----	-----
	375,871	188,108
	-----	-----
TOTAL ASSETS.....	\$29,735,242	\$23,455,840
	=====	=====

</TABLE>

The accompanying notes are an integral part of these financial statements.

UNITED SEMICONDUCTOR CORPORATION  
BALANCE SHEET

LIABILITIES AND STOCKHOLDERS' EQUITY

	1998	1997
	-----	-----
<TABLE>		
<CAPTION>		
<S>	<C>	<C>
CURRENT LIABILITIES		
Short-term loans (Note 4(7)).....	\$ 781,944	\$ 1,911,632
Notes payable (Note 5).....	--	125,209
Accounts payable		
-- third parties.....	461,646	513,371
-- related parties (Note 5).....	23,634	21,485
Accrued expenses (Note 5).....	811,301	578,013
Other payables.....	1,213,782	359,172
Current portion of long-term loans (Note 4(8)).....	1,571,458	656,744
Other current liabilities.....	6,607	1,268
	-----	-----
	4,870,372	4,166,894
	-----	-----
LONG-TERM LIABILITIES		
Long-term loans (Note 4(8)).....	7,041,589	5,190,525
	-----	-----
OTHER LIABILITIES		
Accrued pension liabilities.....	24,958	11,619
	-----	-----
Total Liabilities.....	11,936,919	9,369,038
	-----	-----
STOCKHOLDERS' EQUITY		
Common stock (Note 4(10)).....	13,367,809	10,000,000
Capital reserve generated from the gain on disposal of fixed assets.....	40	40
Retained earnings (Note 4(11))		
-- Legal reserve.....	408,676	--
-- Unappropriated earnings.....	4,022,045	4,086,762
Cumulative translation adjustment.....	(247)	--
	-----	-----
Total stockholders' equity.....	17,798,323	14,086,802
	-----	-----
COMMITMENTS AND CONTINGENT LIABILITIES (NOTE 7)		
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....	\$29,735,242	\$23,455,840
	=====	=====
</TABLE>		

The accompanying notes are an integral part of these financial statements.

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UNITED SEMICONDUCTOR CORPORATION

STATEMENT OF INCOME  
FOR THE YEARS ENDED DECEMBER 31,  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS  
EXCEPT EARNINGS PER SHARE DATA)

	1998	1997
	-----	-----
<TABLE>		
<CAPTION>		
<S>	<C>	<C>
Operating Revenues		
Sales revenues.....	\$12,614,679	\$10,003,022
Sales returns.....	(186,848)	(21,216)
Sales allowance.....	(634,954)	(302,184)
	-----	-----
Net sales.....	11,792,877	9,679,622
Other operating revenues.....	183,553	81,542
	-----	-----
Net operating revenues.....	11,976,430	9,761,164
	-----	-----
Operating Cost		
Cost of goods sold.....	(6,748,200)	(5,278,405)
Other operating cost.....	(129,181)	(38,604)
	-----	-----
	(6,877,381)	(5,317,009)
	-----	-----

Gross Profit.....	5,099,049	4,444,155
Operating Expenses		
Selling expenses.....	(218,789)	(88,841)
Administrative expenses.....	(214,364)	(265,943)
Research and development expenses.....	(701,179)	(443,866)
	(1,134,332)	(798,650)
Operating Income.....	3,964,717	3,645,505
Non-operating Income		
Interest income.....	368,695	264,153
Dividends revenue.....	28,010	21,420
Gain on disposal of investment.....	41,516	16,956
Foreign exchange gain.....	--	397,616
Gain on reverse of allowance on inventory loss.....	59,540	--
Other income.....	5,370	6,853
	503,131	706,998
Non-operating Expenses		
Interest expense.....	(464,199)	(354,973)
Foreign exchange loss.....	(71,071)	--
Provision for loss on obsolescence of inventories.....	--	(50,562)
Financial expense.....	(10,919)	(391)
Other loss.....	(103,307)	(419)
	(649,496)	(406,345)
Income before income tax.....	3,818,352	3,946,158
Income tax (expense) benefit (Note 4(12)).....	(69,803)	84,057
Net income.....	\$ 3,748,549	\$ 4,030,215
Earnings per share (Note 4(13))		
Net income.....	\$ 2.80	\$ 3.01

</TABLE>

The accompanying notes are an integral part of these financial statements.

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UNITED SEMICONDUCTOR CORPORATION

STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
FOR THE YEARS ENDED DECEMBER 31,  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

<TABLE>

<CAPTION>

	COMMON STOCK	CAPITAL RESERVE	RETAINED EARNINGS		CUMULATIVE TRANSLATION ADJUSTMENT FROM LONG-TERM INVESTMENTS	TOTAL STOCKHOLDERS' EQUITY
			LEGAL RESERVE	UNAPPROPRIATED EARNINGS		
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Balance at January 1, 1997...	\$10,000,000	\$--	\$ --	\$ 56,587	\$ --	\$10,056,587
Net income for 1997.....	--	--	--	4,030,215	--	4,030,215
Transfer of the gain on disposal of fixed assets to capital reserve.....	--	40	--	(40)	--	--
Balance at December 31, 1997.....	10,000,000	40	--	4,086,762	--	14,086,802
Appropriation of 1997 earnings:						
Appropriation for legal reserve.....	--	--	408,676	(408,676)	--	--
Capitalization of employees' bonus.....	367,809	--	--	(367,809)	--	--
Directors' and supervisors' remuneration.....	--	--	--	(36,781)	--	(36,781)
Stock dividends.....	3,000,000	--	--	(3,000,000)	--	--
Net income for 1998.....	--	--	--	3,748,549	--	3,748,549
Cumulative translation						

adjustment.....	--	--	--	--	(247)	(247)
	-----	---	-----	-----	----	-----
Balance at December 31, 1998.....	\$13,367,809	\$40	\$408,676	\$ 4,022,045	\$ (247)	\$17,798,323
	=====	===	=====	=====	=====	=====

</TABLE>

The accompanying notes are an integral part of these financial statements.

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UNITED SEMICONDUCTOR CORPORATION

STATEMENT OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31,  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

<TABLE>  
<CAPTION>

	1998	1997
	-----	-----
<S>	<C>	<C>
<b>OPERATING ACTIVITIES:</b>		
Net income.....	\$ 3,748,549	\$ 4,030,215
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation.....	2,510,951	1,591,371
Amortization.....	363,314	320,071
(Reverse of) Provision for loss on obsolescence of inventories.....	(47,943)	38,403
(Loss) gain on disposal of fixed assets.....	15	(40)
Fixed assets transferred to expenses.....	4,759	26,516
Changes in asset and liability accounts:		
Accounts and notes receivable.....	653,888	(1,026,445)
Other receivables.....	(76,241)	(24,017)
Inventories.....	(105,915)	(64,203)
Prepaid expenses.....	9,866	(5,673)
Other current assets.....	137,028	(208,429)
Deferred income tax assets.....	(135,019)	116,684
Other assets.....	(2,231)	--
Accounts and notes payable.....	(174,785)	213,748
Accrued expenses and other payable.....	233,288	283,571
Other current liabilities.....	(908)	5,911
Accrued pension liabilities.....	13,339	11,619
	-----	-----
Net cash provided by operating activities.....	7,131,955	5,309,302
	-----	-----
<b>INVESTING ACTIVITIES:</b>		
Acquisition of fixed assets.....	(6,280,177)	(4,644,743)
Proceeds from disposal of fixed assets.....	--	9,180
Decrease (increase) in marketable securities.....	52,353	(2,987,926)
Increase in long-term investment.....	(356,406)	--
Increase in deferred expense and intangible assets.....	(128,858)	(25,882)
Decrease (increase) in deposits-out.....	29,504	(915)
	-----	-----
Net cash used in investing activities.....	(6,683,584)	(7,650,286)
	-----	-----
<b>FINANCING ACTIVITIES:</b>		
Decrease (increase) in short-term loans.....	(1,129,688)	1,750,112
Proceeds from long-term loans.....	2,765,778	1,517,771
Appropriation of directors' and supervisors' remuneration.....	(36,781)	--
	-----	-----
Net cash provided by financing activities.....	1,599,309	3,267,883
	-----	-----
Net increase in cash and cash equivalents.....	2,047,680	926,899
Cash and cash equivalents at the beginning of year.....	5,469,227	4,542,328
	-----	-----
Cash and cash equivalents at the end of year.....	\$ 7,516,907	\$ 5,469,227
	=====	=====
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash paid for interest (excluding interest capitalized)...	\$ 444,233	\$ 345,781
	=====	=====
Cash paid for income tax.....	\$ 1,744	\$ 51,501
	=====	=====
<b>INVESTING ACTIVITIES PARTIALLY PAID BY CASH</b>		
Acquisition of fixed assets.....	\$ 7,154,510	\$ 3,445,946
Add: payable at the beginning of year.....	352,925	1,551,722

Less: payable at the end of year.....	(1,213,782)	(352,925)
Fixed assets exchange.....	(13,476)	--
	-----	-----
Cash paid.....	\$ 6,280,177	\$ 4,644,743
	=====	=====

</TABLE>

The accompanying notes are an integral part of these financial statements.

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UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 1998 AND 1997

(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

1. HISTORY AND ORGANIZATION

United Semiconductor Corporation was incorporated as a company limited by shares on October 6, 1995 and commenced its operations in June, 1996. As of December 31, 1998, the paid-in capital is \$13,367,809. The Company's major business activities are as follows:

- a. Semiconductor and semiconductor device foundry;
- b. Providing the mask tooling, package, burn-in, and testing services for the above-mentioned products; and
- c. Research and development for the technology of wafer fabrication.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Translation of foreign currency transactions

The accounts of the Company are maintained in New Taiwan dollars. Transactions denominated in foreign currencies are translated into New Taiwan dollars at the rates of exchange prevailing on the transaction dates. Receivables, other monetary assets and liabilities denominated in foreign currencies are translated into New Taiwan dollars at the rates of exchange prevailing at the balance sheet date. Exchange gains or losses are included in the current year's results.

Cash equivalents

Cash equivalents are short-term, highly liquid investments, which are readily convertible to known amounts of cash and with maturity dates that do not present significant risk of changes in value because of changes in interest rates.

Marketable securities

Marketable securities are recorded at cost when acquired. The carrying amount of the marketable securities portfolio is stated at the lower of its aggregate cost or market value at the balance sheet date. The market value for listed equity securities or close-ended funds are determined by the average closing prices occurred during the last month of the fiscal year. The market value for open-ended funds are determined by their equity per unit at balance sheet date.

Inventories

Inventories, except raw materials stated at actual, are stated at standard cost which is adjusted to actual cost based on weighted average method at month end. Inventories are valued at the lower of cost or market value at the year end. An allowance for loss on obsolescence and decline in market value is provided when necessary.

Long-term investments

A. If the investee company is listed and the Company owns less than 20% of the outstanding shares and has no significant influence on operational decisions of the listed company, such investment is accounted for by the lower of cost or market value method. The unrealized loss resulting from the decline in market value of such investment is deducted from stockholders' equity. The Company's investment in a company which is not listed is accounted for under the cost method.

## UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
 DECEMBER 31, 1998 AND 1997  
 (EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

B. Investment income or loss from investments in both listed and unlisted companies is accounted for under equity method provided that the Company owns over 20% of the outstanding shares or has significant influence on operational decisions of the listed and unlisted companies.

C. For long-term investments in which the Company owns more than 50% of the subsidiary, consolidated financial statements are prepared, if the total assets and the operating income of the subsidiary are less than 10% of the respective nonconsolidated total assets and income of the Company, the subsidiary's financial statements are not consolidated and instead are accounted for using the equity method. Irrespective of the above test, when the total combined assets or operating income of all such nonconsolidated subsidiaries constitute more than 30% of the Company's nonconsolidated total assets or income, then each individual subsidiary with total assets or operating income greater than 3% of the Company's respective nonconsolidated total assets and income is included in the consolidation.

D. In evaluation of overseas long-term investment, the cumulative translation adjustment derived from the investee's foreign currency financial statements is treated as adjusted item of the Company's stockholders' equity account.

## Property, plant and equipment

A. Property, plant and equipment are stated at cost. Interest incurred on loans used to finance the construction of property and plant is capitalized and depreciated accordingly.

B. Depreciation is provided on the straight-line method using the assets' economic service lives. When the economic service lives are completed, fixed assets which are still in use are depreciated based on the residual value. The service lives of the fixed assets are five to ten years.

C. Maintenance and repairs are charged to expenses as incurred. Significant renewals and improvements are treated as capital expenditures and are depreciated accordingly.

## Intangible assets

A. Technology knowhow was provided by a major shareholder as part of paid-in capital. The asset is amortized over five years on the straight-line method starting from the date of operation.

B. Royalties are stated at cost and amortized on a straight-line basis over the contract period.

## Deferred charges

Deferred charges are stated at cost and amortized on a straight-line basis over the following years: software -- 3 years; organization cost -- 5 years.

## Retirement plan

A. The Company has a non-contributory and funded defined benefit retirement plan covering all its regular employees.

B. The net pension cost is computed based on an actuarial valuation in accordance with the provision of FASB No. 18 of the R.O.C., which requires consideration of cost components such as service cost, interest cost, expected return on plan assets and amortization of net obligation at transition.

## UNITED SEMICONDUCTOR CORPORATION

## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Income tax

Income tax is provided based on accounting income after adjusting for permanent differences. The provision for income tax includes deferred tax resulting from items reported in different periods for tax and financial reporting purposes and from investment tax credits. A valuation allowance is provided for deferred tax asset to the extent that it is more likely than not that the tax benefits will not be realized. Deferred tax assets or liabilities are further classified into current or noncurrent items and are presented in the financial statements as net balance. Over or under provision of prior years' income tax liabilities are included in the current year's income tax expense.

3. EFFECT OF CHANGE IN ACCOUNTING PRINCIPLES

None.

4. CONTENTS OF SIGNIFICANT ACCOUNTS

(1) CASH AND CASH EQUIVALENTS

<TABLE>

<CAPTION>

	DECEMBER 31	
	1998	1997
<S>	<C>	<C>
Cash:		
Cash on hand.....	\$ 2,355	\$ 1,817
Demand accounts.....	387,694	58,655
Checking accounts.....	169,402	16,607
Time deposits.....	6,054,016	5,342,348
	-----	-----
	6,613,467	5,419,427
Cash equivalents:		
Bonds with repurchase agreement.....	903,440	49,800
	-----	-----
	\$7,516,907	\$5,469,227
	=====	=====

</TABLE>

(2) MARKETABLE SECURITIES

<TABLE>

<CAPTION>

	DECEMBER 31	
	1998	1997
<S>	<C>	<C>
Mutual funds.....	\$ 199,040	\$ 251,393
Listed equity securities stocks.....	2,939,353	2,939,353
	-----	-----
	\$3,138,393	\$3,190,746
	=====	=====

</TABLE>

(3) ACCOUNTS RECEIVABLE -- NET

<TABLE>

<CAPTION>

	DECEMBER 31	
	1998	1997
<S>	<C>	<C>
Accounts receivable -- third parties.....	\$863,417	\$959,159
Less: Allowance for doubtful accounts.....	(20,982)	(21,839)
Less: Allowance for sales returns and discounts.....	(64,036)	--
	-----	-----
	\$778,399	\$937,320
	=====	=====

</TABLE>

## UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
 DECEMBER 31, 1998 AND 1997  
 (EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

## (4) INVENTORIES

<TABLE>  
 <CAPTION>

	DECEMBER 31	
	1998	1997
<S>	<C>	<C>
Raw materials, supplies and spare parts.....	\$ 88,653	\$226,426
Work in process.....	445,414	315,274
Finished goods.....	171,737	58,189
	705,804	599,889
Less: Allowance for loss on obsolescence.....	(40,460)	(88,403)
	\$665,344	\$511,486

</TABLE>

## (5) LONG-TERM INVESTMENT

<TABLE>  
 <CAPTION>

INVESTEE COMPANY	DECEMBER 31			
	1998		1997	
	AMOUNT	PERCENTAGE OF OWNERSHIP	AMOUNT	PERCENTAGE OF OWNERSHIP
<S>	<C>	<C>	<C>	<C>
Investment accounted for under equity method:				
UMC-USA.....	\$106,006	20%	\$--	--
Cumulative translation adjustment.....	(247)		--	
Subtotal.....	105,759		--	
Prepaid long-term investment:				
Industrial Bank of Taiwan.....	250,000		--	
SBIP Administration Recycle Co.....	400		--	
Subtotal.....	250,400		--	
Grand total.....	\$356,159		\$--	

</TABLE>

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## UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
 DECEMBER 31, 1998 AND 1997  
 (EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

## (6) PROPERTY, PLANT AND EQUIPMENT

<TABLE>  
 <CAPTION>

	COST	ACCUMULATED DEPRECIATION	BOOK VALUE
<S>	<C>	<C>	<C>
DECEMBER 31, 1998			
Machinery and equipment.....	\$18,591,271	\$ (4,387,198)	\$14,204,073
Transportation equipment.....	3,206	(1,122)	2,084
Furniture and fixtures.....	217,742	(53,978)	163,764
Leasehold improvements.....	10,966	(4,142)	6,824
Other equipment.....	40,974	(5,850)	35,124
Construction in progress and			

prepayments.....	967,065	--	967,065
	-----	-----	-----
	\$19,831,224	(4,452,290)	15,378,934
	=====	=====	=====
DECEMBER 31, 1997			
Machinery and equipment.....	\$10,169,495	\$(1,915,540)	\$ 8,253,955
Transportation equipment.....	3,206	(587)	2,619
Furniture and fixtures.....	130,771	(24,341)	106,430
Leasehold improvements.....	10,966	(2,315)	8,651
Other equipment.....	14,270	(2,178)	12,092
Construction in progress and prepayments.....	2,460,306	--	2,460,306
	-----	-----	-----
	\$12,789,014	\$(1,944,961)	\$10,844,053
	=====	=====	=====

</TABLE>

Interest expense amounting to \$118,745 and \$24,321 were capitalized in 1998 and 1997, respectively.

(7) SHORT-TERM LOANS

<TABLE>  
<CAPTION>

	DECEMBER 31	
	-----	-----
	1998	1997
	-----	-----
<S>	<C>	<C>
Unsecured loans.....	\$781,944	\$1,911,632
	=====	=====
Annual interest rates.....	0.73% - 8.22%	1.25% - 7.66%
	=====	=====

</TABLE>

(8) LONG-TERM LOANS

<TABLE>  
<CAPTION>

	DECEMBER 31	
	-----	-----
	1998	1997
	-----	-----
<S>	<C>	<C>
Long-term loans.....	\$ 8,613,047	\$5,847,269
Less: Current portion.....	(1,571,458)	(656,744)
	-----	-----
	\$ 7,041,589	\$5,190,525
	=====	=====
Annual interest rates.....	1.25% - 7.60%	1.31% - 7.20%
	=====	=====

</TABLE>

(9) RETIREMENT PLAN

A. All of the regular employees of the Company are covered by the pension plan. Under the plan, the Company contributes an amount equal to 2% of total wages on a monthly basis to the pension fund deposited in the Central Trust of China. Pension benefits are generally based on service years (two points per year for service years 15 years and below and one point per year for service years over 15 years). Each employee is limited up to 45 points. During 1998 and 1997, the Company recognized pension cost amounting to \$22,262

and \$17,793, respectively. The balances of the Company's employees' retirement fund in Central Trust of China was \$18,068 and \$9,270 at December 31, 1998 and 1997, respectively.

B. Based on actuarial assumptions for the years of 1998 and 1997, both the discount rate and expected rate of return on plan asset are 6.25% and 6.5%, respectively and the rates of compensation increase are both 8%. The

unrecognized net obligation at transition is amortized equally over 15 years. The funded status of pension plan is listed as follows:

<TABLE>  
<CAPTION>

	DECEMBER 31	
	1998	1997
<S>	<C>	<C>
Vested benefit obligation.....	\$ --	\$ --
Non-vested benefit obligation.....	(11,417)	(4,947)
Accumulated benefit obligation.....	(11,417)	(4,947)
Effect on projected salary increase.....	(57,082)	(25,388)
Projected benefit obligation.....	(68,499)	(30,335)
Market-related value of plan assets.....	18,068	8,638
Projected benefit obligation exceeds plan asset.....	(50,431)	(21,697)
Unrecognized net obligation at transition.....	260	281
Unrecognized pension gain or loss.....	26,647	11,360
Accrued pension liability.....	\$ (23,524)	\$ (10,056)

</TABLE>

(10) COMMON STOCK

A. As of December 31, 1998, the Company's authorized capital was \$23,000,000, representing 2,300,000 thousand shares, with par value of NT\$10. The total issued and outstanding capital at December 31, 1998 and 1997 were \$13,367,809 and \$10,000,000, respectively.

B. Based on the resolution of the shareholders' meeting on May 26, 1998, the Company issued new shares of 336,781 thousand shares from the capitalization of retained earnings of \$3,000,000 and employees' bonus of \$367,809. The Company has completed the amendment procedures for registration.

(11) RETAINED EARNINGS

A. According to the Company's Articles of Incorporation, current year's earnings, if any, shall be distributed in the following order:

- (1) paying all taxes and dues;
- (2) covering prior years' operating losses, if any;
- (3) setting aside 10% of the remaining amount, after deducting (1) and (2), as legal reserve;
- (4) allocating not over 10% of par value of common stocks as interest of capital to common stockholders;
- (5) allocating 1% of the remaining amount, after deducting (1), (2), (3) and (4) above from the current year's earnings, as directors' and supervisors' remuneration;
- (6) allocating not below 10% of the remaining amount, after deducting (1), (2), (3) and (4) above from the current year's earnings, as employees' bonus; and

UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
DECEMBER 31, 1998 AND 1997  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

(7) distributing the remaining amount in accordance with the resolution of the board of directors and stockholders.

(12) INCOME TAX

A. Income tax receivable at December 31, 1998 and 1997 was derived as follows:

<TABLE>  
<CAPTION>

	1998	1997
	-----	-----
<S>	<C>	<C>
Income tax expense (benefit).....	\$ 69,803	\$ (84,057)
Net effect of the change in deferred income tax assets and liabilities.....	(54,187)	89,634
Adjustment of prior year's income tax expense.....	(3,101)	--
Withholding income tax.....	(34,994)	(51,259)
Tax on interest which is subject to separate withholding income tax.....	(1,744)	(242)
	-----	-----
Income tax receivable (shown in other current assets).....	\$ (24,223)	\$ (45,924)
	=====	=====

</TABLE>

B. Deferred income tax assets and liabilities as of December 31, 1998 and 1997 were as follows:

<TABLE>  
<CAPTION>

	DECEMBER 31	
	1998	1997
	-----	-----
<S>	<C>	<C>
Deferred income tax assets -- current.....	\$ 43,335	\$ 228,270
Deferred income tax liabilities -- current.....	(4,271)	--
	-----	-----
	39,064	228,270
	-----	-----
Deferred income tax assets -- noncurrent.....	1,526,536	1,262,960
Deferred income tax liabilities -- noncurrent.....	(470,012)	(611,435)
Valuation allowance for deferred income tax assets -- noncurrent.....	(818,403)	(548,423)
	-----	-----
	238,121	103,102
	-----	-----
	\$ 277,185	\$ 331,372
	=====	=====

</TABLE>

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UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
DECEMBER 31, 1998 AND 1997  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

C. Components of deferred income tax assets and liabilities as of December 31, 1998 and 1997 were as follows:

<TABLE>  
<CAPTION>

	DECEMBER 31, 1998		DECEMBER 31, 1997	
	AMOUNT	TAX EFFECT	AMOUNT	TAX EFFECT
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
Current items:				
Temporary differences				
Unrealized foreign exchange gain.....	\$ 195,322	\$ 39,064	\$ 1,141,350	\$ 228,270
	-----	-----	-----	-----
Non-current items:				
Temporary differences				
Depreciation.....	(2,350,062)	(470,012)	(3,057,175)	(611,435)
Amortization of technology knowhow, etc.....	135,180	27,036	956,290	191,258
Investment tax credits.....	--	1,499,500	--	1,071,702
Valuation allowance for deferred income tax assets.....	--	(818,403)	--	(548,423)

-----	-----	-----	-----
\$ (2,214,882)	238,121	\$ (2,100,885)	103,102
=====	-----	=====	-----
	\$ 277,185		\$ 331,372
	=====		=====

</TABLE>

D. The Company's income tax return for 1996 has been assessed and approved by the Tax Authority.

E. Pursuant to the "Statute For The Establishment and Administration of Science-Based Industrial Park", the Company was granted several periods of tax holidays with respect to income derived from approved investments. The tax holidays will be expired on December, 2001.

F. As of December 31, 1998, the unused investment tax credits amounting to \$1,499,500 resulting from the acquisition of equipment and expenditures on research and development will expire on December 31, 2002.

G. As of December 31, 1998, the Company's deductible credit account balance for shareholders' income tax is \$36,733. The ending balance of unappropriated earnings amounting to \$4,022,045, of which \$3,748,549 came from the year of 1998 and \$273,496 came from and before the years of 1997. The estimated ratio of deductible tax credit for the appropriation of 1998's earnings is 0.33%.

(13) EARNINGS PER SHARE

<TABLE>

<CAPTION>

	1998	1997
	-----	-----
<S>	<C>	<C>
Net income.....	\$3,748,549	\$4,030,215
	=====	=====
Weighted average outstanding common stock (Expressed in thousand shares).....	1,336,781	1,000,000
	=====	=====
Retroactively adjusted weighted average outstanding common stock (Expressed in thousand shares).....	1,336,781	1,336,781
	=====	=====
Earnings per share (Expressed in New Taiwan dollars).....	\$ 2.80	\$ 4.03
	=====	=====
Retroactively adjusted weighted average earnings per share.....	\$ 2.80	\$ 3.01
	=====	=====

</TABLE>

UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
DECEMBER 31, 1998 AND 1997  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

5. RELATED PARTY TRANSACTION

(1) NAMES AND RELATIONSHIPS OF RELATED PARTIES

<TABLE>

<CAPTION>

NAME OF THE RELATED PARTIES	THE RELATIONSHIP WITH THE COMPANY
-----	-----
<S>	<C>
United Microelectronics Co., Ltd. (UMC)	The major investor of the Company
United Integrated Circuits Corporation	Common board chairman
United Silicon Incorporated	Common board chairman
Utek Semiconductor Inc.	Common board chairman
AMIC Technology, Incorporated	The affiliate of UMC
Faraday Technology Corporation	Common major investor
NOVATEK Microelectronics Corp.	Common major investor
Integrated Technology Express	Common major investor
MediaTek Incorporation	Common major investor
Industrial Bank of Taiwan	The Company is the promoter

Chiao Tung Bank	The Company's chairman is a board member of the Bank
S3 Inc.	A director of the Company
S3 International Ltd.	100% investee of S3 Inc.
ALLIANCE Semiconductor Corp. (Alliance)	A director of the Company
UMC-USA	The investee of the Company

(2) SIGNIFICANT RELATED PARTY TRANSACTIONS

a. Sales

	1998		1997	
	AMOUNT	PERCENTAGE OF NET SALES	AMOUNT	PERCENTAGE OF NET SALES
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd.....	\$1,562,443	13%	\$2,503,897	26%
United Integrated Circuit Co., Ltd.....	229,583	2%	302,866	3%
S3 International Ltd.....	1,456,778	12%	--	--
Alliance.....	271,453	2%	--	--
Others.....	108,098	1%	425,071	4%
	-----	-----	-----	-----
	\$3,628,355	30%	\$3,231,834	33%
	=====	==	=====	==

The above sales are dealt with in the ordinary course of business similar to those with other companies. The actual collection period is approximately two months.

UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
DECEMBER 31, 1998 AND 1997  
(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

b. Purchases

	1998		1997	
	AMOUNT	PERCENTAGE OF NET PURCHASES	AMOUNT	PERCENTAGE OF NET PURCHASES
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd.....	\$ 69,942	3%	\$15,912	2%
United Silicon Incorporated.....	17,115	1%	--	--
United Integrated Circuit Co., Ltd.....	19,060	1%	--	--
	-----	-----	-----	-----
	\$106,117	5%	\$ 15912	2%
	=====	==	=====	==

The above purchases are dealt with in the ordinary course of business similar to those with other companies and are payable after two months from the date of transaction entries.

c. Notes receivable

	1998		1997	
		PERCENTAGE OF NOTES		PERCENTAGE OF NOTES
<S>				

	AMOUNT	RECEIVABLE	AMOUNT	RECEIVABLE
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd....	\$ --	--	\$781	100%
AMIC Technology Incorporated.....	6,736	79%	--	--
Faraday Technology Corporation.....	812	10%	--	--
Integrated Technology Express.....	804	9%	--	--
	-----	-----	-----	-----
	\$8,352	98%	\$781	100%
	=====	==	=====	===

</TABLE>

d. Accounts receivable

<TABLE>

<CAPTION>

	1998		1997	
	AMOUNT	PERCENTAGE OF ACCOUNTS RECEIVABLE	AMOUNT	PERCENTAGE OF ACCOUNTS RECEIVABLE
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd. ....	\$303,987	22%	\$218,633	11%
United Integrated Circuits Co., Ltd.....	--	--	317,533	17%
S3 International Ltd.....	140,624	10%	263,252	14%
Others.....	79,157	6%	148,453	8%
	-----	-----	-----	-----
	523,768	38%	947,871	50%
Less: Allowance for doubtful accounts.....	(4,541)	--	(8,207)	--
Less: Allowance for sales returns and discounts.....	(82,290)	(6)%	--	--
	-----	-----	-----	-----
	\$436,937	32%	\$939,664	50%
	=====	==	=====	==

</TABLE>

e. Notes payable

<TABLE>

<CAPTION>

	1998		1997	
	AMOUNT	PERCENTAGE OF NOTES PAYABLE	AMOUNT	PERCENTAGE OF NOTES PAYABLE
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd...	\$--	--	\$25,992	21%
	==	==	=====	==

</TABLE>

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UNITED SEMICONDUCTOR CORPORATION

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 1998 AND 1997

(EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

f. Accounts payable

<TABLE>

<CAPTION>

	1998		1997	
	AMOUNT	PERCENTAGE OF ACCOUNTS PAYABLE	AMOUNT	PERCENTAGE OF ACCOUNTS PAYABLE
	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd.....	\$20,776	4%	\$ 9,428	2%
United Integrated Circuit Co., Ltd.....	1,281	--	12,057	2%

United Silicon Incorporated.....	1,577	1%	--	--
	-----	--	-----	-----
	\$23,634	5%	\$21,485	4%
	=====	==	=====	==

</TABLE>

g. Accrued expenses

<TABLE>  
<CAPTION>

	1998		1997	
	AMOUNT	PERCENTAGE OF ACCRUED EXPENSES	AMOUNT	PERCENTAGE OF ACCRUED EXPENSES
<S>	<C>	<C>	<C>	<C>
United Microelectronics Co., Ltd.....	\$190,761	24%	77,387	\$13%
Others.....	197	--	--	--
	-----	--	-----	---
	\$190,958	24%	\$77,387	13%
	=====	==	=====	===

</TABLE>

h. Property transaction

1998: None.

1997: The Company sold one set of machinery and equipment to United Integrated Circuit Co., Ltd. for \$9,180. The gain on the transaction was \$40.

i. Financing transaction -- Long-term loan

<TABLE>  
<CAPTION>

	THE HIGHEST BALANCE				
	TIME	AMOUNT	ENDING BALANCE	INTEREST RATE	INTEREST EXPENSE PAID
<S>	<C>	<C>	<C>	<C>	<C>
1998					
Chiao-Tung Bank.....	February 1998	\$720,144	\$576,112	6.575% - 6.975%	\$44,824
		=====	=====		=====
1997					
Chiao-Tung Bank.....	December 1997	\$720,144	\$720,144	6.575%	\$40,409
		=====	=====		=====

</TABLE>

j. Other transactions

<TABLE>  
<CAPTION>

RELATED PARTIES	ITEM	1998	1997
<S>	<C>	<C>	<C>
United Microelectronics Co., Ltd. ....	Rental	\$201,211	\$199,329
United Microelectronics Co., Ltd. ....	Fab service charge	87,696	64,954
United Microelectronics Co., Ltd. ....	Research & design expense	168,420	76,992
United Microelectronics Co., Ltd. ....	Technology developing expense	145,911	--
United Microelectronics Co., Ltd. ....	Management allocation fee	69,915	--
		-----	-----
		673,153	341,275
UMC-USA.....	Commission	137,272	--
		-----	-----
		\$810,425	\$341,275
		=====	=====

</TABLE>

NOTES TO FINANCIAL STATEMENTS (CONTINUED)  
 DECEMBER 31, 1998 AND 1997  
 (EXPRESSED IN NEW TAIWAN THOUSAND DOLLARS)

6. ASSETS PLEDGED AS COLLATERAL

<TABLE>  
 <CAPTION>

	DECEMBER 31		SUBJECT OF COLLATERAL
	1998	1997	
<S>	<C>	<C>	<C>
Machinery and equipment.....	\$12,575,024	\$6,272,029	Long-term loan
Deferred assets-software.....	53,690	--	Long-term loan
Time deposits.....	2,231	2,111	Guaranty for Customs Duties
	-----	-----	
	\$12,630,945	\$6,274,140	
	=====	=====	

</TABLE>

7. COMMITMENTS AND CONTINGENT LIABILITIES

a. The Company's unused letters of credit for import machinery were approximately USD25,510 thousand dollars, JPY3,516,992 thousand dollars, and DEM120 thousand dollars at December 31, 1998.

b. The Company has signed several contracts for the purchase of equipment amounting to USD1,204,098 thousand dollars, JPY91,153,936 thousand dollars, and DEM703 thousand dollars. As of December 31, 1998, the amount of unrecorded outstanding obligations under these contracts are USD1,101,281 thousand dollars, JPY77,117,921 thousand dollars, and DEM120 thousand dollars.

c. On September 24, 1997, the Department of Commerce (DOC) of the United States of America (USA) made a preliminary determination that Static Random Access Memory (SRAM) manufactured in Taiwan are being sold at less than fair market value, i.e. dumped prices. In March, 1998, the DOC issued its final determination, setting the duty rate at 41.75% for "all others" not named as direct participants in the investigation (such as customers who used the Company to fabricate SRAM). Management believes that this final ruling of the case will not have a material adverse effect on the Company's financial position because the volume of SRAM products exported by the Company to the USA is not significant.

d. On December 7, 1998, the International Trade Commission (ITC) of the USA issued a statement to the DOC that there was a reasonable indication that the U.S. industry is suffering a material injury as a result of Dynamic Random Access Memory (DRAM), which are manufactured in Taiwan and being sold at less than fair market value in the USA. Based on the precedent set in the SRAM investigation described above, the Company expects that foundry customers who were not participants in the investigation will also be subject to the "all other" rate with respect to DRAM. Management believes that the final outcome of the investigation will not have a material adverse effect to the Company's financial position because the Company's volume of export sales of DRAM to the USA is not significant.

e. A number of third parties hold patents in the area of semiconductor processing, and some have notified the Company demanding that the Company obtain a license for various semiconductor fabrication techniques and circuit designs. The third parties involved include Texas Instruments, EMI, Intel, Chou H. Li, NEC, and Sanyo. Management has indicated a willingness to obtain licenses wherever required and necessary to continue its business.

8. COMPARATIVE FIGURES RECLASSIFICATION

Certain accounts in the 1997 financial statements have been reclassified to conform with the presentation adopted for the 1998 financial statements.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

On March 31, 1998, the Company informed Deloitte & Touche LLP ("Deloitte"), its former independent accountants, that effective immediately they had been dismissed as the Company's principal independent accountants. During the

Company's fiscal year ended December 31, 1996 and through March 31, 1998, there were no disagreements with Deloitte on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to Deloitte's satisfaction, would have caused them to make reference to the subject matter of such disagreement in connection with their Report on the financial statement for such periods, except as follows: in connection with the audit of the Company's financial statements for the year ended December 31, 1997, there was a disagreement between Deloitte and the Company regarding the appropriate period in which to recognize the gain on the sale of stock of an investee. Deloitte believed that recognition of such gain should be deferred until the period in which the exchange actually occurred (first quarter of 1998) while the Company initially believed that recognition of such gain was appropriate in the period the irrevocable contract was signed (fourth quarter of 1997). Recognition of the gain was deferred as proposed by Deloitte. On January 21, 1998, Deloitte discussed this disagreement with the Audit Committee of the Company. The Company has authorized Deloitte to respond fully to the inquiries of the successor accountant concerning the subject matter of such disagreement.

Deloitte's Report dated January 23, 1998 on the Company's financial statements for the year ended December 31, 1997 did not contain an adverse opinion or a disclaimer of opinion, and such Report was not qualified or modified as to uncertainty, audit scope or accounting principles.

The decision to dismiss Deloitte was recommended by the Company's Audit Committee and approved by its Board of Directors.

On April 13, 1998, the Company engaged the firm of Ernst & Young LLP as accountants to audit the Company's financial statements commencing with its 1998 fiscal year.

The Company did not, during its fiscal year ended December 31, 1997 and through April 13, 1998 consult with or receive any written or oral advice from Ernst & Young LLP regarding (i) any matter, including the application of accounting principles to a specified transaction or the type of audit opinion that might be rendered on the Company's financial statements, which advice was an important factor considered by the Company in reaching a decision as to such accounting, auditing or financial reporting issue or (ii) any disagreement with Deloitte, its former accountants, or any reportable event.

During the Company's fiscal ended December 31, 1997 and 1998, there have been no reportable events.

### PART III

Certain information required by Part III is incorporated by reference from the Company's definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 1999 Annual Meeting of Stockholders (the "Proxy Statement").

#### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The information required by this section is incorporated by reference from the information in the section entitled "Proposal 1 -- Election of Directors" in the Proxy Statement. The required information concerning executive officers of the Company is contained in the section entitled "Executive Officers of the Registrant" in Part I of this Form 10-K.

Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16 of the Exchange Act. This disclosure is contained in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

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#### ITEM 11. EXECUTIVE COMPENSATION.

The information required by this section is incorporated by reference from the information in the sections entitled "Proposal 1 -- Election of Directors -- Directors' Compensation", "Executive Compensation" and "Stock Price Performance Graph" in the Proxy Statement.

#### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The information required by this section is incorporated by reference from the information in the section entitled "Proposal 1 -- Election of

Directors -- Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Not applicable.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.

(a) The following documents are filed as a part of this Form 10-K:

(1) Financial Statements:

Reference is made to the Index to Consolidated Financial Statements of S3 Incorporated and the Index to Financial Statements of United Semiconductor Corporation under Item 8 in Part II of this Form 10-K.

(2) Financial Statement Schedules:

The following financial statement schedule of S3 Incorporated for the years ended December 31, 1998, 1997 and 1996 is filed as part of this Report and should be read in conjunction with the Consolidated Financial Statements of S3 Incorporated.

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All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(3) Exhibits:

The exhibits listed below are required by Item 601 of Regulation S-K. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

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EXHIBIT NUMBER -----	NOTES -----	DESCRIPTION OF DOCUMENT -----
<S>	<C>	<C>
3(i).1	(1)	Restated Certificate of Incorporation.
3(i).2	(6)	Certificate of Amendment of Restated Certificate of Incorporation.
3(i).3	(10)	Certificate of Designation of Series A Participating Preferred Stock.
3(i).4		Certificate of Amendment of Restated Certificate of Incorporation.
3(ii)	(10)	Amended and Restated Bylaws.

</TABLE>

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EXHIBIT NUMBER -----	NOTES -----	DESCRIPTION OF DOCUMENT -----
<S>	<C>	<C>
4.1	(1)	Specimen common stock certificate.
4.2	(8)	Indenture, dated as of September 12, 1996 between Registrant and State Street Bank and Trust Company of California, N.A., as Trustee, including the form of Note.
4.3	(9)	Rights Agreement dated as of May 14, 1997 between S3 Incorporated and The First National Bank of Boston, Rights

	Agent.
10.1*	1989 Stock Plan of S3 Incorporated (Amended and Restated as of December 14, 1998) (the "1989 Plan").
10.2*	Form of Incentive Stock Option Agreement under the 1989 Plan.
10.3*	(1) Form of common stock Purchase Agreement under the 1989 Plan.
10.4*	(2) S3 Incorporated 1993 Employee Stock Purchase Plan.
10.5	(1) Form of Indemnification Agreement between the Registrant and its directors.
10.6	(7) Lease between Mission Real Estate, L.P. and Registrant dated November 29, 1995.
10.7	(3) Office Lease dated May 13, 1993, between the Registrant and San Tomas No. 2 Limited Partnership.
10.8	(3) First Amendment of Office Lease dated September 9, 1993, between the Registrant and San Tomas No. 2 Limited Partnership.
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10.11	(4) Second Amendment of Office Lease dated March 30, 1994, between the Registrant and San Tomas No. 2 Limited Partnership.
10.12*	(11) Employment Agreement between Registrant and Terry N. Holdt dated December 18, 1997.
10.13*	Employment Agreement between Registrant and Kenneth F. Potashner, dated October 30, 1998
10.14*	Employment Agreement between Registrant and Ronald T. Yara, dated November 20, 1998
10.15*	Involuntary Termination Agreement between Registrant and Paul G. Franklin, dated September 22, 1998
10.16*	Involuntary Termination Agreement between Registrant and Walter D. Amaral, dated September 30, 1998
10.17*	Involuntary Termination Agreement between Registrant and Daniel A. Karr, dated October 29, 1998
12.1	Statement of Computation of Ratio of Earnings to Fixed Charges
16.1	(12) Letter of Deloitte and Touche LLP regarding change in certifying public accountant
21.1	Subsidiaries of Registrant.
23.1	Consent of Ernst and Young LLP, Independent Auditors (San Jose, California).
23.2	Consent of Deloitte and Touche LLP (San Jose, California).
23.3	Consent of PricewaterhouseCoopers LLP (Hsinchu, Taiwan).
24.1	Power of Attorney (see page 77 of this Form 10-K).
27.1	Financial Data Schedule.

</TABLE>

-----  
 \* Indicates management contract or compensatory plan or arrangement.

- (1) Incorporated by reference from the Registrant's Registration Statement on Form S-1 (File No. 33-57114).
- (2) Incorporated by reference to Exhibit 10.15 to the Registrant's Registration Statement on Form S-8 (File No. 33-65186).
- (3) Incorporated by reference to the exhibit of the same number to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1993.

- (4) Incorporated by reference to the exhibit of the same number to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1994.
- (5) Incorporated by reference to the exhibit of the same number to the Registrant's Current Report on Form 8-K filed July 25, 1995.
- (6) Incorporated by reference to the exhibit of the same number to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1995.
- (7) Incorporated by reference to Exhibit 10.14 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1995.

- (8) Incorporated by reference to Exhibit 4.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.
- (9) Incorporated by reference to Exhibit 4.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.
- (10) Incorporated by reference to the exhibit of the same number to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997.
- (11) Incorporated by reference to Exhibit 10.14 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1997.
- (12) Incorporated by reference to Exhibit 16 to the Registrant's Current Report on Form 8-K filed April 7, 1998.

(b) Reports on Form 8-K:

The following reports on Form 8-K were filed by the Company during the three months ended December 31, 1998: On November 6, 1998, the Company filed a Current Report on Form 8-K with the Securities and Exchange Commission that disclosed, among other things: (i) the appointment of Kenneth F. Potashner as the Company's President and Chief Executive Officer, (ii) the increase in the size of the Company's Board of Directors from five directors to six directors, (iii) the election of Mr. Potashner as Chairman of the Board and (iv) the terms of Mr. Potashner's employment agreement.

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SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996  
(IN THOUSANDS)

<TABLE>  
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DESCRIPTION	BALANCE AT BEGINNING OF PERIOD	CHARGED TO COSTS AND EXPENSES	REVERSALS TO COSTS AND EXPENSES	(DEDUCTIONS)	BALANCE AT END OF PERIOD
-----	-----	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>	<C>
Allowance for doubtful accounts:					
1998.....	\$1,507	\$ 600	\$ --	\$ 189	\$2,296
1997.....	1,438	1,200	--	(1,131)	1,507
1996.....	645	1,522	--	(729)	1,438
Sales returns and allowances:					
1998.....	\$4,157	\$1,453	\$(631)	\$ (750)	\$4,229
1997.....	1,210	4,680	--	(1,733)	4,157
1996.....	969	241	--	--	1,210

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 31, 1999.

S3 INCORPORATED  
(Registrant)

By: /s/ KENNETH F. POTASHNER

-----  
Kenneth F. Potashner  
President  
Chief Executive Officer  
Chairman of the Board

March 31, 1999

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Kenneth F. Potashner, Walter D. Amaral, and Ronald T. Yara, and each of them, his or her true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated:

<S>	SIGNATURE -----	<C>	TITLE -----	<C>	DATE ----
	/s/ KENNETH F. POTASHNER ----- Kenneth F. Potashner		President, Chief Executive Officer Chairman of the Board		March 31, 1999
	/s/ ROBERT P. LEE ----- Robert P. Lee		Director		March 31, 1999
	/s/ WALTER D. AMARAL ----- Walter D. Amaral		Senior Vice President & Chief Financial Officer (Principal Financial and Accounting Officer)		March 31, 1999
	/s/ JOHN C. COLLIGAN ----- John C. Colligan		Director		March 31, 1999
	/s/ TERRY N. HOLDT ----- Terry N. Holdt		Vice Chairman of the Board		March 31, 1999
	/s/ CARMELO J. SANTORO ----- Carmelo J. Santoro		Director		March 31, 1999
	/s/ RONALD T. YARA ----- Ronald T. Yara		Director		March 31, 1999

EXHIBIT INDEX

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3(i).2	(6)		Certificate of Amendment of Restated Certificate of Incorporation.
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12.1		Involuntary Termination Agreement between Registrant and Daniel A. Karr, dated October 29, 1998
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- (12) Incorporated by reference to Exhibit 16 to the Registrant's Current Report on Form 8-K filed April 7, 1998.

CERTIFICATE OF AMENDMENT  
OF  
RESTATED CERTIFICATE OF INCORPORATION  
OF  
S3 INCORPORATED

S3 Incorporated, a corporation organized and existing under and by virtue of the General Corporation Law of the State of Delaware, DOES HEREBY CERTIFY:

FIRST: That the Board of Directors of said corporation at a regular meeting of said Board held on January 14, 1999, duly adopted a resolution proposing and declaring advisable the following amendment to Article IV of the Restated Certificate of Incorporation of said corporation:

ARTICLE IV

A. Number and Classes of Stock. This Corporation is authorized to issue two classes of stock, designated "Preferred Stock" and "Common Stock," respectively. The total number of shares which this Corporation shall have authority to issue is one hundred twenty-five million (125,000,000). The number of shares of Common Stock authorized to be issued is one hundred twenty million (120,000,000) with a par value of \$0.0001. The number of shares of Preferred Stock authorized to be issued is five million (5,000,000) with a par value of \$0.0001. The number of authorized shares of Common Stock or Preferred Stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of a majority of the then outstanding shares of Common Stock, without a vote of the holders of the Preferred Stock, or of any series thereof, unless a vote of any such Preferred Stock holders is required pursuant to the provisions established by the Board of Directors of this Corporation (the "Board of Directors") in the resolution or resolutions providing for the issue of such Preferred Stock, and if such holders of such Preferred Stock are so entitled to vote thereon, then, except as may otherwise be set forth in this Restated Certificate of Incorporation, the only stockholder approval required shall be the affirmative vote of a majority of the combined voting power of the Common Stock and the Preferred Stock so entitled to vote.

B. Preferred Stock. The Preferred Stock may be issued from time to time

in one or more series. The Board of Directors is expressly authorized to provide for the issue, in one or more series, of all or any of the remaining shares of Preferred Stock and, in the resolution or resolutions providing for such issue, to establish for each such series the number of its shares, the voting powers, full or limited, of the shares of such series, or that such shares shall have no voting powers, and the designations, preferences and relative, participating, optional or other special rights of the shares of such series, and the qualifications, limitations or restrictions

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thereof. The Board of Directors is also expressly authorized (unless forbidden in the resolution or resolutions providing for such issue) to increase or decrease (but not below the number of shares of the series then outstanding) the number of shares of any series subsequent to the issuance of shares of that series. In case the number of shares of any such series shall be so decreased, the shares constituting such decrease shall resume the status that they had prior to the adoption of the resolution originally fixing the number of shares of such series.

C. Common Stock.

1. Relative Rights of Preferred Stock and Common Stock. All preferences, voting powers, relative, participating, optional or other special rights and privileges, and qualifications, limitations or restrictions of the Common Stock are expressly made subject and subordinate to those that may be fixed with respect to any shares of the Preferred Stock.

2. Voting Rights. Except as otherwise required by law or this Restated Certificate of Incorporation, each holder of Common Stock shall have one vote in respect of each share of stock held by such holder of record on the books of the corporation for the election of directors and on all matters submitted to a vote of stockholders of the corporation.

3. Dividends. Subject to the preferential rights of the Preferred Stock, the holders of shares of Common Stock shall be entitled to receive, when and if declared by the Board of Directors, out of the assets of this Corporation which are by law available therefor, dividends payable either in cash, in property or in shares of capital stock.

4. Dissolution, Liquidation or Winding Up. In the event of any dissolution, liquidation or winding up of the affairs of this Corporation, after distribution in full of the preferential amounts, if any, to be distributed to the holders of shares of the Preferred Stock, holders of Common Stock shall be entitled, unless otherwise provided by law or this Restated Certificate of Incorporation, to receive all of the remaining assets of the corporation of whatever kind available for distribution to stockholders ratably in proportion

to the number of shares of Common Stock held by them respectively.

SECOND: Pursuant to a special meeting and vote of stockholders, the stockholders have given consent to said amendment in accordance with the provisions of Section 242 of the General Corporation Law of Delaware.

THIRD: That the aforesaid amendment was duly adopted in accordance with the applicable provisions of Section 242 of the General Corporation Law of the State of Delaware.

IN WITNESS WHEREOF, S3 Incorporated has caused this certificate to be signed this 25th day of February, 1999.

By /s/ Walter D. Amaral

-----

Walter D. Amaral  
Senior Vice President and  
Chief Financial Officer

1989 STOCK PLAN OF

S3 INCORPORATED

(Amended and Restated as of December 14, 1998)

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1989 STOCK PLAN OF

S3 INCORPORATED

(Amended and Restated as of December 14, 1998)

SECTION 1. ESTABLISHMENT AND PURPOSE.

The Plan was established in 1989 to offer selected employees, directors, advisers and consultants an opportunity to acquire a proprietary interest in the success of the Company, or to increase such interest, by purchasing Shares of the Company's Common Stock. The Plan provides both for the direct award or sale of Shares and for the grant of Options to purchase Shares. Options granted under the Plan may include Nonstatutory Options as well as ISOs intended to qualify under Code section 422.

The Plan was amended and restated as of December 14, 1998 to incorporate prior amendments, to amend the provisions governing grants to Outside Directors, to increase the number of shares which may be issued upon the exercise of ISOs and to extend the term of the Plan.

SECTION 2. DEFINITIONS.

(a) "Board of Directors" shall mean the Board of Directors of the Company, as constituted from time to time.

(b) "Change in Control" means the occurrence of either of the following events:

(i) A change in the composition of the Board of Directors, as a result of which fewer than one-half of the incumbent directors are directors who either:

(A) Had been directors of the Company twenty-four (24) months prior to such change; or

(B) Were elected, or nominated for election, to the Board of Directors with the affirmative votes of at least a majority of the directors who had been directors of the Company twenty-four (24) months prior to such change and who were still in office at the time of the election or nomination; or

(ii) Any "person" (as such term is used in sections 13(d) and 14(d) of the Exchange Act) by the acquisition or aggregation of securities is or becomes the beneficial owner, directly or indirectly, of securities of the Company representing twenty percent (20%) or more of the combined voting power of the Company's then outstanding securities ordinarily (and apart from rights accruing under special circumstances) having the right to vote at elections of directors (the "Base Capital Stock"); except that any

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change in the relative beneficial ownership of the Company's securities by any person resulting solely from a reduction in the aggregate number of outstanding shares of Base Capital Stock, and any decrease thereafter in such person's ownership of securities, shall be disregarded until such person increases in any manner, directly or indirectly, such person's beneficial ownership of any securities of the Company. For purposes of this Subsection (ii), the term "person" shall not include an employee benefit plan maintained by the Company.

(c) "Code" shall mean the Internal Revenue Code of 1986, as amended.

(d) "Committee" shall mean the committee designated by the Board of Directors, which is authorized to administer the Plan under Section 3 hereof. The Committee shall have membership composition which enables the Options or other rights granted under the Plan to qualify for exemption under Rule 16b-3 with respect to persons who are subject to Section 16 of the Exchange Act.

(e) "Company" shall mean S3 Incorporated, a Delaware corporation.

(f) "Employee" shall mean (i) any individual who is a common-law employee of the Company or of a Subsidiary, (ii) a member of the Board of Directors and (iii) an independent contractor or advisor who performs services for the Company or a Subsidiary. Service as a member of the Board of Directors or as an independent contractor or advisor shall be considered employment for all purposes of the Plan except the second sentence of Section 4(a) and Section 4(b).

(g) "Exchange Act" shall mean the Securities Exchange Act of 1934, as amended.

(h) "Exercise Price" shall mean the amount for which one Share may be purchased upon exercise of an Option, as specified by the Committee in the applicable Stock Option Agreement.

(i) "Fair Market Value" shall mean (i) the closing price of a Share on the principal exchange which the Shares are trading, on the date on which the Fair Market Value is determined (if Fair Market Value is determined on a date which the principal exchange is closed, Fair Market Value shall be determined on the last immediately preceding trading day), or (ii) if the Shares are not traded on an exchange but are quoted on the Nasdaq National Market or a successor quotation system, the closing price on the date on which the Fair Market Value is determined, or (iii) if the Shares are not traded on an exchange or quoted on the Nasdaq National Market or a successor quotation system, the fair market value of a Share, as determined by the Committee in good faith. Such determination shall be conclusive and binding on all persons.

(j) "ISO" shall mean an employee incentive stock option described in Code section 422.

(k) "Nonstatutory Option" shall mean an employee stock option that is not an ISO.

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(l) "Offeree" shall mean an individual to whom the Committee has offered the right to acquire Shares under the Plan (other than upon exercise of an Option).

(m) "Option" shall mean an ISO or Nonstatutory Option granted under the Plan and entitling the holder to purchase Shares.

(n) "Optionee" shall mean an individual who holds an Option.

(o) "Outside Director" shall mean a member of the Board of Directors who is not a common-law employee of the Company or of a Subsidiary.

(p) "Plan" shall mean this 1989 Stock Plan of S3 Incorporated, as amended

from time to time.

(q) "Purchase Price" shall mean the consideration for which one Share may be acquired under the Plan (other than upon exercise of an Option), as specified by the Committee.

(r) "Service" shall mean service as an Employee."

(s) "Share" shall mean one share of Stock, as adjusted in accordance with Section 9 (if applicable).

(t) "Stock" shall mean the Common Stock of the Company.

(u) "Stock Option Agreement" shall mean the agreement between the Company and an Optionee which contains the terms, conditions and restrictions pertaining to his Option.

(v) "Stock Purchase Agreement" shall mean the agreement between the Company and an Offeree who acquires Shares under the Plan which contains the terms, conditions and restrictions pertaining to the acquisition of such Shares.

(w) "Subsidiary" shall mean any corporation, if the Company and/or one or more other Subsidiaries own not less than 50 percent of the total combined voting power of all classes of outstanding stock of such corporation. A corporation that attains the status of a Subsidiary on a date after the adoption of the Plan shall be considered a Subsidiary commencing as of such date.

(x) "Total and Permanent Disability" shall mean that the Optionee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted, or can be expected to last, for a continuous period of not less than six (6) months.

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### SECTION 3. ADMINISTRATION.

(a) Committee Procedures. The Board of Directors shall designate one of the members of the Committee as chairman. The Committee may hold meetings at such times and places as it shall determine. The acts of a majority of the Committee members present at meetings at which a quorum exists, or acts reduced to or approved in writing by all Committee members, shall be valid acts of the Committee.

(b) Committee Responsibilities. Subject to the provisions of the Plan, the Committee shall have full authority and discretion to take the following actions:

(i) To interpret the Plan and to apply its provisions;

(ii) To adopt, amend or rescind rules, procedures and forms relating to the Plan;

(iii) To authorize any person to execute, on behalf of the Company, any instrument required to carry out the purposes of the Plan;

(iv) To determine when Shares are to be awarded or offered for sale and when Options are to be granted under the Plan;

(v) To select the Offerees and Optionees;

(vi) To determine the number of Shares to be offered to each Offeree or to be made subject to each Option;

(vii) To prescribe the terms and conditions of each award or sale of Shares, including (without limitation) the Purchase Price, the vesting of the award (including accelerating the vesting of awards) and to specify the provisions of the Stock Purchase Agreement relating to such award or sale;

(viii) To prescribe the terms and conditions of each Option, including (without limitation) the Exercise Price, the vesting or duration of the Option (including accelerating the vesting of the Option), to determine whether such Option is to be classified as an ISO or as a Nonstatutory Option, and to specify the provisions of the Stock Option Agreement relating to such Option;

(ix) To amend any outstanding Stock Purchase Agreement or Stock Option Agreement, subject to applicable legal restrictions and to the consent of the Offeree or Optionee who entered into such agreement;

(x) To prescribe the consideration for the grant of each Option or other right under the Plan and to determine the sufficiency of such consideration;

(xi) To determine the disposition of each Option or other right under the Plan in the event of an Optionee's or Offeree's divorce or dissolution of marriage;

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(xii) To determine whether Options or other rights under the Plan will be granted in replacement of other grants under an incentive or other compensation plan of an acquired business;

(xiii) To correct any defect, supply any omission, or reconcile any

inconsistency in the Plan, any Stock Option Agreement or any Stock Purchase Agreement; and

(xiv) To take any other actions deemed necessary or advisable for the administration of the Plan.

Subject to the requirements of applicable law, the Committee may designate persons other than members of the Committee to carry out its responsibilities and may prescribe such conditions and limitations as it may deem appropriate, except that the Committee may not delegate its authority with regard to the selection for participation of or the granting of Options or other rights under the Plan to persons subject to Section 16 of the Exchange Act. All decisions, interpretations and other actions of the Committee shall be final and binding on all Offerees, all Optionees, and all persons deriving their rights from an Offeree or Optionee. No member of the Committee shall be liable for any action that he has taken or has failed to take in good faith with respect to the Plan, any Option, or any right to acquire Shares under the Plan.

#### SECTION 4. ELIGIBILITY.

(a) General Rule. Only Employees shall be eligible for designation as Optionees or Offerees by the Committee. In addition, only individuals who are employed as common-law employees by the Company or a Subsidiary shall be eligible for the grant of ISOs.

(b) Outside Directors. Any other provision of the Plan notwithstanding, the participation of Outside Directors in the Plan shall be subject to the following restrictions:

(i) Outside Directors shall only be eligible for the grant of Nonstatutory Options as described in this Section 4(b).

(ii) Each Outside Director shall automatically be granted a Nonstatutory Option to purchase 40,000 Shares (subject to adjustment under Section 9) as a result of their appointment as an Outside Director. Subject to paragraph (iii) below, upon the conclusion of each regular annual meeting of the Company's stockholders following the meeting at which they were appointed, each Outside Director who will continue serving as a member of the Board thereafter shall receive a Nonstatutory Option to purchase 20,000 Shares (subject to adjustment under Section 9). All such Nonstatutory Options shall vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the date the

option is granted to the Outside Director. No Shares shall vest after

termination of the Outside Director's Service.

(iii) Each Outside Director who serves on the Board on December 14, 1998 shall automatically be granted a Nonstatutory Option to purchase 100,000 Shares (subject to adjustment under Section 9); provided that such Nonstatutory Options shall be lieu of any Nonstatutory Options that would otherwise be granted to the Outside Director pursuant to paragraph (ii) above before the 2004 annual meeting of the Company's stockholders. Such Nonstatutory Options shall vest and become exercisable as follows: 20,000 shares vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the regular annual meeting of the Company's stockholders occurring in calendar year 1999; 20,000 shares vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the regular annual meeting of the Company's stockholders occurring in calendar year 2000; 20,000 shares vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the regular annual meeting of the Company's stockholders occurring in calendar year 2001; 20,000 shares vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the regular annual meeting of the Company's stockholders occurring in calendar year 2002; and 20,000 shares vest and become exercisable at the rate of twenty-five percent (25%) upon each one (1) year anniversary of the regular annual meeting of the Company's stockholders occurring in calendar year 2003. No Shares shall vest after termination of the Outside Director's Service.

(iv) All Nonstatutory Options granted to an Outside Director under this Section 4(b) shall also become exercisable in full in the event of (A) the termination of such Outside Director's service because of death or Total and Permanent Disability or (B) a Change in Control of the Company.

(v) The Exercise Price of all Nonstatutory Options granted to an Outside Director under this Section 4(b) shall be equal to one hundred percent (100%) of the Fair Market Value of a Share on the date of grant, payable in one of the forms described in Sections 8(a), (b) and (d).

(vi) All Nonstatutory Options granted to an Outside Director under this Section 4(b) shall terminate on the earliest of (A) the 10th anniversary of the date of grant of such Options, (B) the date ninety (90) days after the termination of such Outside Director's service for any reason other than death, Total and Permanent Disability or voluntary retirement as an Outside Director at or after the age of 60, or (C) the date twelve (12) months after the termination of such Outside Director's service because of death, Total and Permanent Disability or voluntary retirement as an Outside Director at or after the age of 60.

(c) Limitation On Grants. No Employee shall be granted Options to purchase more than 1,500,000 Shares in any fiscal year of the Company; provided, however, that with respect to fiscal year 1998, the 1,500,000 Share limit shall be increased to 4,500,000 Shares.

(d) Ten-Percent Stockholders. An Employee who owns more than 10 percent of the total combined voting power of all classes of outstanding stock of the Company or any of its Subsidiaries shall not be eligible for the grant of an ISO unless such grant satisfies the requirements of Code section 422(c)(6).

(e) Attribution Rules. For purposes of Subsection (d) above, in determining stock ownership, an Employee shall be deemed to own the stock owned, directly or indirectly, by or for his brothers, sisters, spouse, ancestors and lineal descendants. Stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust shall be deemed to be owned proportionately by or for its shareholders, partners or beneficiaries.

(f) Outstanding Stock. For purposes of Subsection (d) above, "outstanding stock" shall include all stock actually issued and outstanding immediately after the grant. "Outstanding stock" shall not include shares authorized for issuance under outstanding options held by the Employee or by any other person.

#### SECTION 5. STOCK SUBJECT TO PLAN.

(a) Basic Limitation. Shares offered under the Plan shall be authorized but unissued Shares or treasury Shares. As of December 14, 1999, 26,253,105 shares have been reserved for issuance under the Plan (upon exercise of Options or other rights to acquire Shares), which includes the 4,500,000 Shares reserved for issuance on October 20, 1998. On each January 1 for the remaining term of the Plan, the aggregate number of Shares which may be issued under the Plan to individuals other than Outside Directors (upon exercise of Options or other rights to acquire Shares) shall be increased by a number of Shares equal to 3 1/4 percent of the total number of Shares of the Common Stock of the Company outstanding at the end of the most recently concluded calendar year. Any Shares that have been reserved but not issued as Shares or Options during any calendar year shall remain available for grant during any subsequent calendar year. Notwithstanding the foregoing, no more than 36,000,000 Shares may be issued under ISOs for the remaining term of the Plan. The aggregate number of Shares which may be issued under the Plan shall at all times be subject to adjustment pursuant to Section 9. The number of Shares which are subject to Options or other rights outstanding at any time under the Plan shall not exceed the number of Shares which then remain available for issuance under the Plan. The Company, during the term of the Plan, shall at all times reserve and keep available sufficient Shares to satisfy the requirements of the Plan.

(b) Additional Shares. In the event that any outstanding Option or other right for any reason expires or is canceled or otherwise terminated, the Shares allocable to the unexercised portion of such Option or other right shall again be available for the purposes of the Plan. If Shares are forfeited before any dividends have been paid with respect to the Shares, then such Shares shall

again be available for award or sale under the Plan.

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#### SECTION 6. TERMS AND CONDITIONS OF AWARDS OR SALES.

(a) Stock Purchase Agreement. Each award or sale of Shares under the Plan (other than upon exercise of an Option) shall be evidenced by a Stock Purchase Agreement between the Offeree and the Company. Such award or sale shall be subject to all applicable terms and conditions of the Plan and may be subject to any other terms and conditions which are not inconsistent with the Plan and which the Committee deems appropriate for inclusion in a Stock Purchase Agreement. The provisions of the various Stock Purchase Agreements entered into under the Plan need not be identical.

(b) Duration of Offers and . Any right to acquire Shares under the Plan (other than an Option) shall automatically expire if not exercised by the Offeree within thirty (30) days after the grant of such right was communicated to him by the Committee. Such right shall not be transferable and shall be exercisable only by the Offeree to whom such right was granted.

(c) Purchase Price. The Purchase Price shall be determined by the Committee at its sole discretion. The Purchase Price shall be payable in one of the forms described in Sections 8(a) and (c).

(d) Withholding Taxes. As a condition to the purchase of Shares, the Offeree shall make such arrangements as the Committee may require for the satisfaction of any federal, state or local withholding tax obligations that may arise in connection with such purchase.

(e) Restrictions on Transfer of Shares. Any Shares awarded or sold under the Plan shall be subject to such special forfeiture conditions, rights of repurchase, rights of first refusal and other transfer restrictions as the Committee may determine. Such restrictions shall be set forth in the applicable Stock Purchase Agreement and shall apply in addition to any general restrictions that may apply to all holders of Shares.

#### SECTION 7. TERMS AND CONDITIONS OF OPTIONS.

(a) Stock Option Agreement. Each grant of an Option under the Plan shall be evidenced by a Stock Option Agreement between the Optionee and the Company. Such Option shall be subject to all applicable terms and conditions of the Plan and may be subject to any other terms and conditions which are not inconsistent with the Plan and which the Committee deems appropriate for inclusion in a Stock Option Agreement. The provisions of the various Stock Option Agreements entered into under the Plan need not be identical.

(b) Number of Shares. Each Stock Option Agreement shall specify the number of Shares that are subject to the Option and shall provide for the

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adjustment of such number in accordance with Section 9. The Stock Option Agreement shall also specify whether the Option is an ISO or a Nonstatutory Option.

(c) Exercise Price. Each Stock Option Agreement shall specify the Exercise Price. The Exercise Price of an ISO shall not be less than 100 percent of the Fair Market Value of a Share on the date of grant, except as otherwise provided in Section 4(d). Subject to the preceding sentence, the Exercise Price under any Option shall be determined by the Committee at its sole discretion. The Exercise Price shall be payable in one of the forms described in Sections 8(a), (b) and (d).

(d) Withholding Taxes. As a condition to the exercise of an Option, the Optionee shall make such arrangements as the Committee may require for the satisfaction of any federal, state or local withholding tax obligations that may arise in connection with such exercise. The Optionee shall also make such arrangements as the Committee may require for the satisfaction of any federal, state or local withholding tax obligations that may arise in connection with the disposition of Shares acquired by exercising an Option.

(e) Exercisability and Term. Each Stock Option Agreement shall specify the date when all or any installment of the Option is to become exercisable. The Stock Option Agreement shall also specify the term of the Option. The term shall not exceed ten (10) years from the date of grant, except as otherwise provided in Section 4(d). Subject to the preceding three sentences, the Committee at its sole discretion shall determine when all or any installment of an Option is to become exercisable and when an Option is to expire.

(f) Nontransferability. During an Optionee's lifetime, his Option(s) shall be exercisable only by him and shall not be transferable. In the event of an Optionee's death, his Option(s) shall not be transferable other than by will or by the laws of descent and distribution.

(g) Exercise of Options Upon Termination of Service. Each Stock Option Agreement shall set forth the extent to which the Optionee shall have the right to exercise the Option following termination of the Optionee's Service with the Company and its Subsidiaries, and the right to exercise the Option of any executors or administrators of the Optionee's estate or any person who has acquired such Option(s) directly from the Optionee by bequest or inheritance. Such provisions shall be determined in the sole discretion of the Committee, need not be uniform among all Options issued pursuant to the Plan, and may

reflect distinctions based on the reasons for termination of Service.

(h) Leaves of Absence. An Optionee's Service shall be deemed to continue while the Optionee is on military leave, sick leave or other bona fide leave of absence (as determined by the Committee). The foregoing notwithstanding, in the case of an ISO granted under the Plan, Service shall not be deemed to continue beyond the first ninety (90) days of such leave, unless the Optionee's reemployment rights are guaranteed by statute or by contract.

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(i) No Rights as a Stockholder. An Optionee, or a transferee of an Optionee, shall have no rights as a stockholder with respect to any Shares covered by his Option until the date of the issuance of a stock certificate for such Shares. No adjustments shall be made, except as provided in Section 9.

(j) Modification, Extension and Renewal of Options. Within the limitations of the Plan, the Committee may modify, extend or renew outstanding options or may accept the cancellation of outstanding options (to the extent not previously exercised), whether or not granted hereunder, in return for the grant of new Options at the same or a different price. The foregoing notwithstanding, no modification of an Option shall, without the consent of the Optionee, impair his rights or increase his obligations under such Option.

(k) Restrictions on Transfer of Shares. Any Shares issued upon exercise of an Option shall be subject to such special forfeiture conditions, rights of repurchase, rights of first refusal and other transfer restrictions as the Committee may determine. Such restrictions shall be set forth in the applicable Stock Option Agreement and shall apply in addition to any general restrictions that may apply to all holders of Shares.

#### SECTION 8. PAYMENT FOR SHARES.

(a) General Rule. The entire Purchase Price or Exercise Price of Shares issued under the Plan shall be payable in lawful money of the United States of America at the time when such Shares are purchased, except as provided in Subsections (b), (c) and (d) below.

(b) Surrender of Stock. To the extent that a Stock Option Agreement so provides, payment may be made all or in part with Shares which have already been owned by the Optionee or his representative for more than twelve (12) months and which are surrendered to the Company in good form for transfer. Such Shares shall be valued at their Fair Market Value on the date when the new Shares are purchased under the Plan.

(c) Services Rendered. At the discretion of the Committee, Shares may be

awarded under the Plan in consideration of services rendered to the Company or a Subsidiary prior to the award. If Shares are awarded without the payment of a Purchase Price in cash, the Committee shall make a determination (at the time of the award) of the value of the services rendered by the Offeree and the sufficiency of the consideration to meet the requirements of Section 6(c).

(d) Cashless Exercise. To the extent that a Stock Option Agreement so provides, payment may be made all or in part by delivery (on a form prescribed by the Committee) of an irrevocable direction to a securities broker to sell Shares and to deliver all or part of the sale proceeds to the Company in payment of the aggregate Exercise Price.

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#### SECTION 9. ADJUSTMENT OF SHARES.

(a) General. In the event of a subdivision of the outstanding Stock, a declaration of a dividend payable in Shares, a declaration of a dividend payable in a form other than Shares in an amount that has a material effect on the value of Shares, a combination or consolidation of the outstanding Stock (by reclassification or otherwise) into a lesser number of Shares, a recapitalization or a similar occurrence, the Committee shall make appropriate adjustments in one or more of (i) the number of Shares available for future grants under Section 5, (ii) the number of Shares available for grants under Section 4(c), (iii) the number of Shares covered by each outstanding Option, (iv) the Exercise Price under each outstanding Option, (v) the number of shares covered by each outstanding award or (vi) the Purchase Price of each outstanding award.

(b) Reorganizations. In the event that the Company is a party to a merger or other reorganization, outstanding Options shall be subject to the agreement of merger or reorganization. Such agreement may provide for the assumption of outstanding Options by the surviving corporation or its parent or for their continuation by the Company (if the Company is a surviving corporation); provided, however, that if assumption or continuation of the outstanding Options is not provided by such agreement then the Committee shall have the option of offering the payment of a cash settlement equal to the difference between the amount to be paid for one Share under such agreement and the Exercise Price, in all cases without the Optionees' consent.

(c) Reservation of Rights. Except as provided in this Section 9, an Optionee or Offeree shall have no rights by reason of any subdivision or consolidation of shares of stock of any class, the payment of any dividend or any other increase or decrease in the number of shares of stock of any class. Any issue by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number or

Exercise Price of Shares subject to an Option. The grant of an Option pursuant to the Plan shall not affect in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure, to merge or consolidate or to dissolve, liquidate, sell or transfer all or any part of its business or assets.

#### SECTION 10. LEGAL AND REGULATORY REQUIREMENTS.

Shares shall not be issued under the Plan unless the issuance and delivery of such Shares complies with (or is exempt from) all applicable requirements of law, including (without limitation) the Securities Act of 1933, as amended, the rules and regulations promulgated thereunder, state securities laws and regulations and the regulations of any stock exchange on which the Company's securities may then be listed, and the Company has obtained the approval or favorable ruling from any governmental agency which the Company determines is necessary or advisable.

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#### SECTION 11. NO EMPLOYMENT RIGHTS.

No provision of the Plan, nor any right or Option granted under the Plan, shall be construed to give any person any right to become, to be treated as, or to remain an Employee. The Company and its Subsidiaries reserve the right to terminate any person's Service at any time and for any reason, with or without notice.

#### SECTION 12. DURATION AND AMENDMENTS.

(a) Term of the Plan. The amended and restated Plan, as set forth herein, shall terminate automatically on December 13, 2008 and may be terminated on any earlier date pursuant to Subsection (b) below.

(b) Right to Amend or Terminate the Plan. The Board of Directors may amend the Plan at any time and from time to time. Rights and obligations under any Option granted before amendment of the Plan shall not be materially altered, or impaired adversely, by such amendment, except with consent of the person to whom the Option was granted. An amendment of the Plan shall be subject to the approval of the Company's stockholders only to the extent required by applicable laws, regulations or rules.

(c) Effect of Amendment or Termination. No Shares shall be issued or sold under the Plan after the termination thereof, except upon exercise of an Option granted prior to such termination. The termination of the Plan, or any amendment thereof, shall not affect any Share previously issued or any Option previously

granted under the Plan.

SECTION 13. EMPLOYEES BASED OUTSIDE OF THE UNITED STATES.

Notwithstanding any provision of the Plan to the contrary, in order to foster and promote achievement of the purposes of the Plan or to comply with provisions of laws or regulations in other countries in which the Company and its Subsidiaries operate or have employees, the Committee, in its sole discretion, shall have the power and authority to (a) determine which Employees outside the United States are eligible to participate in the Plan, (b) modify the terms and conditions of any Options granted to Employees outside the United States and (c) establish subplans, modified option exercise procedures and other terms and procedures to the extent such actions may be necessary or advisable.

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SECTION 14. EXECUTION

To record the adoption of the amended and restated Plan by the Board of Directors effective as of December 14, 1998, the Company has caused its authorized officer to execute the same.

S3 INCORPORATED

By

-----  
Walter D. Amaral  
Senior Vice President Finance and  
Chief Financial Officer

## 1989 STOCK PLAN OF S3 INCORPORATED

## INCENTIVE STOCK OPTION AGREEMENT

INCENTIVE STOCK  
OPTION

This option is intended to be an incentive stock option under section 422 of the Internal Revenue Code and will be interpreted accordingly. Nevertheless, to the extent that it exceeds the \$100,000 rule of section 422(d) of the Internal Revenue Code, this option will be treated as a nonstatutory stock option.

## VESTING

Your right to exercise this Option vests daily over the four year period beginning on the Grant Date ("Effective Date") shown on the cover sheet. In addition, if your Service terminates due to your death or Total and Permanent Disability, your right to exercise this Option will vest as to an additional 50% of the Shares subject to this Option at that time (or, if less, the entire remaining unvested Shares). All vested Share calculations will be rounded up to the nearest whole number. No additional Shares vest after your Company Service has terminated for any reason.

Notwithstanding the foregoing, if your Service terminates within one year of the Effective Date you will not be entitled to exercise any portion of this Option, unless your Service terminates due to your death or Total and Permanent Disability. If your Service terminates within one year of the Effective Date due to your death or Total and Permanent Disability, then your right to exercise this Option shall vest as to the number of Shares subject to the Option calculated under the daily vesting schedule set forth above, plus an additional 50% of the Shares subject to this Option.

## TERM

Your Option will expire in any event at the close of business at Company headquarters on the day before the 10th anniversary of the Date of Grant, as shown on the cover sheet. (It will expire earlier if your Company Service terminates, as described below.)

## REGULAR TERMINATION

If your Service terminates for any reason except death or Total and Permanent Disability, then your Option will expire at the close of business at Company headquarters

three months after your termination date. During that three-month period, you may exercise the portion of your Option that was vested on the termination date.

Subject to the vesting rules above, in the event that your Service terminates within one year from the Effective Date for any reason, all rights to purchase Shares under this Option shall immediately terminate, unless your Service terminates within one year from the Effective Date due to your death or your Total and Permanent Disability.

The Company determines when your Service terminates for all purposes under the Plan and this Agreement.

#### DEATH

If you die prior to termination of Service, then your Option will expire at the close of business at Company headquarters on the date six months

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after the date of death. During that six-month period, your estate or heirs may exercise the portion of your Option that was vested on the date of death as set forth above.

#### DISABILITY

If your Service terminates because of your Total and Permanent Disability, then your Option will expire at the close of business at Company headquarters on the date six months after your termination date. During that six-month period, you may exercise the portion of your Option that was vested on the date of termination as set forth above.

"Total and Permanent Disability" means that you are unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted, or can be expected to last, for a continuous period of not less than six months.

#### LEAVES OF ABSENCE

For purposes of this option, your Service does not terminate when you go on a military leave, a sick leave or another bona fide leave of absence, if the leave was approved by the Company in writing, if the terms of the leave provide for continued service crediting, or when

continued service crediting is required by applicable law. However, your Service will be treated as terminating 90 days after you went on leave, unless your right to return to active work is guaranteed by law or by a contract. Your Service terminates in any event when the approved leave ends, unless you immediately return to active work.

The Company determines which leaves count for this purpose and the extent to which the vested portion of an Option may be exercised during a leave of absence..

#### RESTRICTIONS ON EXERCISE

The Company will not permit you to exercise this Option if the issuance of Shares at that time would violate any law or regulation.

#### NOTICE OF EXERCISE

When you wish to exercise this Option, you must notify the Company by filing the proper "Notice of Exercise" form at the address given on the form. Your Notice of Exercise must specify how many Shares you wish to purchase. Your Notice of Exercise must also specify how your Shares should be registered (in your name only, in your and your spouse's names as community property or as joint tenants with right of survivorship or in a trust for your benefit). The Notice of Exercise will be effective when it is received by the Company.

If someone else wants to exercise this Option after your death, that person must prove to the Company's satisfaction that he or she is entitled to do so.

#### FORM OF PAYMENT

When you submit your Notice of Exercise, you must include payment of the Exercise Price for the Shares you are purchasing. Payment may be made in one (or a combination) of the following forms:

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- o Your personal check, a cashier's check or a money order.
- o Irrevocable directions to a securities broker approved by the Company to sell the Shares acquired upon exercise of your Option and to deliver all or a portion of the sale proceeds to the Company in payment of the Exercise Price. The balance of the

sale proceeds, if any, will be delivered to you. The directions must be given by signing a special "Notice of Exercise" form provided by the Company.

- o Shares which have already been owned by you for more than twelve months and which are surrendered to the Company. The value of the Shares, determined as of the effective date of the Option exercise, will be applied to the Exercise Price.

#### WITHHOLDING TAXES

You will not be allowed to exercise this Option unless you make acceptable arrangements to pay any withholding taxes that may be due as a result of the Option exercise.

#### RESTRICTIONS ON RESALE

By signing this Agreement, you agree not to sell any Shares acquired upon exercise of this Option at a time when applicable laws, regulations or Company or underwriter trading policies prohibit a sale.

#### TRANSFER OF OPTIONS

Prior to your death, only you may exercise this Option. You cannot transfer or assign this Option. For instance, you may not sell this Option or use it as security for a loan. If you attempt to do any of these things, this Option will immediately become invalid. You may, however, dispose of this Option in your will.

Regardless of any marital property settlement agreement, the Company is not obligated to honor a Notice of Exercise from your former spouse, nor is the Company obligated to recognize your former spouse's interest in your Option in any other way.

#### RETENTION RIGHTS

Neither your Option nor this Agreement give you the right to be retained by the Company in any capacity. The Company reserves the right to terminate your Service at any time and for any reason.

#### STOCKHOLDER RIGHTS

Neither you, nor your estate or heirs, have any rights as a stockholder of the Company until a certificate for the Shares acquired upon exercise of your Option has been issued. No adjustments are made for dividends or other rights if the applicable record date occurs before your stock certificate is issued, except as described in the Plan.

#### ADJUSTMENTS

In the event of a stock split, a stock dividend or a similar change in the Company Stock, the number of Shares covered by this Option and the Exercise Price per Share may be adjusted pursuant to the Plan. Your Option shall be subject to the terms of the agreement of

merger, liquidation or reorganization in the event the Company is subject to such corporate activity.

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APPLICABLE LAW

This Agreement will be interpreted and enforced under the laws of the State of California.

THE PLAN AND OTHER

The text of the Plan is incorporated in this Agreement by reference. Capitalized terms that are used in this Agreement but not defined, herein are defined in the Plan as such may be amended from time to time.

This Agreement and the Plan constitute the entire understanding between you and the Company regarding this Option. Any prior agreements, commitments or negotiations concerning this Option are superseded.

BY SIGNING THE COVER SHEET OF THIS AGREEMENT, YOU AGREE TO ALL OF THE TERMS AND CONDITIONS DESCRIBED ABOVE AND IN THE PLAN.

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S3 INCORPORATED  
P. O. BOX 58058  
2801 MISSION COLLEGE BLVD.  
SANTA CLARA, CA 95052-8058  
TELEPHONE: (408) 588-8000  
FACSIMILE: (408) 980-5445

October 30, 1998

Mr. Kenneth Potashner  
16452 Avenida de los Olivos  
Rancho Santa Fe, CA 92067

Dear Ken:

This letter agreement (the "Agreement") sets forth the terms and conditions of your employment with S3 Incorporated (the "Company").

In consideration of the mutual covenants and promises made in this Agreement, you and the Company agree as follows:

1. Employment. Commencing as of October 30, 1998 (the "Effective Date") and during the Term, you will be employed on a full-time basis as President and Chief Executive Officer of the Company. The Company's Board of Directors (the "Board") has also elected you to serve as a director and as its Chairman, effective as of such date. During the Term, you will be given such duties, responsibilities and authority as are appropriate to such positions. During the Term, you will perform and discharge well and faithfully such duties for the Company as are set forth in the bylaws of the Company regarding its Chairman of the Board, President and Chief Executive Officer and such other duties relating to the Company's business, administration and policies as may be reasonably assigned or requested from time to time by the Company's Board of Directors (the "Board"). You will devote your full working time, attention and efforts to the affairs of the Company during the Term; provided, however, (i) you may continue to serve as a member of the Board of Directors of Maxwell Technologies, Inc. ("Maxwell") during your employment with the Company, and (ii) you may provide transition services of limited duration to Maxwell following the termination of your employment with Maxwell, provided that such services will in no event interfere in any material respect with your obligations to provide full-time services to the Company. You agree and understand that your obligations to the Company under this Agreement will require your highest level of attention and

commitment.

2. Term. The term of this Agreement will commence on the Effective Date and will continue for three years thereafter, unless earlier terminated as provided herein (the "Term"). Either you or the Company can terminate your employment hereunder, and your services as an officer and employee of the Company and Chairman of its Board, at any time and for any reason, with or without cause and with or without notice. Under certain circumstances you will be entitled to certain payments and other consideration on such termination, pursuant to the terms and provisions of paragraph 10 below.

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Mr. Kenneth Potashner

October 30, 1998

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3. Base Salary. For your services to the Company, you will be paid a base salary, payable in accordance with the Company's usual payroll practices during your full-time employment as President and Chief Executive Officer, at an annualized rate of \$500,000 per year. The Board may, in its sole discretion, increase but not decrease, your base salary each year after review of your performance.

4. Regular Bonus. You will be eligible to receive an annual bonus of up to 200% of your base salary subject to your achievement of performance goals to be mutually determined and your continued full-time employment as President and Chief Executive Officer through the end of each relevant bonus period (typically, a calendar year). The performance goals for the first year will be determined in the first three months following the Effective Date. Your minimum bonus payable immediately following the first anniversary of the Effective Date will be \$250,000. No minimum bonus shall be payable with respect to other periods.

5. Definitions. For purposes of this Agreement:

"Change in Control" means: (i) the consummation of a merger or consolidation of the Company with or into another entity or any other corporate reorganization, if more than 50% of the combined voting power of the continuing or surviving entity's securities outstanding immediately after such merger, consolidation or other reorganization is owned by persons who were not stockholders of the Company immediately prior to such merger, consolidation or other reorganization; or (ii) the sale, transfer or other disposition of all or substantially all of the Company's assets. A transaction will not constitute a Change in Control if its sole purpose is to change the state of the Company's incorporation or to create a holding company that will be owned in substantially the same proportions by the persons who held the Company's securities immediately before such transaction.

"Cause" for termination of your employment with the Company will exist when one or more of the following events has occurred: (i) your fraud or

criminal conduct affecting your employment or toward the Company, (ii) your willful gross misconduct, willful gross neglect of duties or failure to act which materially and adversely affects the business of the Company, or (iii) your engaging in any activity in competition with Company in a material manner (excluding a less than 5% investment in any public company, and excluding your ongoing services as a director of Maxwell if it remains in substantially the same business or another business that does not compete with the Company).

"Constructive Termination" means your termination of your employment with the Company following the occurrence, without your written consent, of one or more of the following events: (i) a diminution in your duties or the assignment to you of duties which are materially inconsistent with your position or which significantly impair your ability to function in your then current position, provided that you provide notice of your objection in writing to such diminution or assignment and the Company fails to rescind the same within two (2) weeks after receipt of your notice; (ii) a reduction in compensation or material reduction in benefits under this Agreement, which reduction is not cured within two (2) weeks following written notice thereof from you; (iii) the Company's requiring you to relocate your residence without your prior written consent from the San Francisco Bay Area, or from any other area to which

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you may voluntarily move with the Company's prior written consent during the Term; or (iv) the unconsented (by you) relocation of the principal place for the rendering of services hereunder to a location more than fifty (50) miles from the present location of the principal executive office of Company.

None of the foregoing will constitute a Constructive Termination to the extent mutually agreed upon in writing by you and the Company in advance of the occurrence thereof. A Constructive Termination will be treated as an involuntary termination by the Company without Cause.

"Disability" means your failure to effectively discharge your duties and to render the services required hereunder due to physical or mental injury, illness or disability for six (6) or more consecutive months or for more than six (6) months in the aggregate during any period of twelve (12) calendar months following the commencement of employment hereunder.

6. Stock Options. You will be granted two stock options. First, you will be granted a nonstatutory stock option (the "1,500,000 Share Option"), in substantially the form of Exhibit A attached hereto, to purchase 1,500,000 shares of the Common Stock of the Company (the "Common Stock") with an exercise

price per share equal to the closing price of the Common Stock on the Effective Date. The 1,500,000 Share Option will be fully vested and exercisable upon the earliest of (i) the six month anniversary of the Effective Date if you are then employed by the Company on a full-time basis, (ii) upon the consummation of a Change in Control if you are employed by the Company immediately prior to such Change in Control on a full-time basis, (iii) the Company's termination of your full-time employment without Cause, or (iv) a Constructive Termination. The 1,500,000 Share Option will terminate on the earlier of the third anniversary of the Effective Date (the Payment Date defined in Section 7 below) or 90 days after termination of your full-time employment by the Company.

Second, you will be granted an incentive stock option (to the extent incentive stock option treatment is available under the annual \$100,000 limit of Section 422(d) of the Internal Revenue Code) in substantially the form attached hereto as Exhibit B to purchase 3,000,000 shares of the Common Stock (the "3,000,000 Share Option") with an exercise price per share equal to the closing price of the Common Stock on the Effective Date. An example of the effect of Section 422(d) of the Internal Revenue Code is set forth on Exhibit C. Subject to the provisions of paragraph 10(b)(iii) and 10(c)(iii) below (which provide for vesting continuation under certain circumstances following a termination without Cause or by Constructive Termination) the 3,000,000 Share Option will vest and become fully exercisable as to 750,000 shares on the first anniversary of the Effective Date if you are then employed by the Company on a full-time basis, and so long as you are so employed by the Company will vest thereafter in equal monthly installments of 62,500 shares, resulting in full vesting in four years if you are still employed on a full-time basis by the Company on the fourth anniversary of the Effective Date. Subject to the aforesaid provisions of paragraph 10(b)(iii) and 10(c)(iii), the 3,000,000 Share Option will terminate on the earlier of the tenth anniversary of the Effective Date or 90 days after termination of your full-time employment by the Company.

7. Special Cash Bonus. On the third anniversary of the Effective Date (or, if applicable, on the date specified in Section 10) (the "Payment Date") you will be paid a "Special Cash Bonus" if:

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(a) Minimum Per Share Spread Not Achieved at End of Applicable Term. The average closing price of the Common Stock over the last 10 trading days immediately preceding the Payment Date is less than the sum of: (i) \$4.67 (\$7,000,000 divided by 1,500,000) plus (ii) the exercise price per share of the 1,500,000 Share Option; and

(b) Minimum Per Share Spread Not Achieved During Each 10-day Period During Three-Year Term. The average closing price of the Common Stock during each and every 10 trading day period that occurs during an open

officers' trading window and that commences six months after the Effective Date and ends on or before the Payment Date is less than the sum of (i) \$4.67 (\$7,000,000 divided by 1,500,000) plus (ii) the exercise price per share of the 1,500,000 Share Option. See Exhibit C for an example of this paragraph (b). For this purpose, an "open officers' trading window" means a period during which officers of the Company are permitted to trade in the Company's Common Stock under the Company's insider trading policy; and

(c) No Hedging. You do not engage in any hedging transaction with respect to the Common Stock prior to the date the Special Cash Bonus would otherwise be payable. A hedging transaction for these purposes shall mean any transaction (other than the exercise of the options and any subsequent sale of any of the Common Stock issued upon exercise thereof) which offsets or reduces or is intended to offset or reduce, in whole or in part, any risk that the value of the Common Stock will decline, including but not limited to a short sale, hedging options and swaps, selling calls, costless calls (i.e., selling puts and using the proceeds to buy calls), pledging of shares of Company common stock to secure a loan on a nonrecourse (to your other assets) basis, or an equity swap; and

(d) Employed For Three Years or Certain Terminations. Either (i) you are still employed by the Company on a full-time basis as its Chief Executive Officer and President on the day prior to the Payment Date, or (ii) your employment is terminated by the Company prior to the Payment Date without Cause or by Constructive Termination.

The Special Cash Bonus, if payable, will be equal to \$7,000,000, less the sum of:

- (i) the number of shares subject to the unexercised portion of the 1,500,000 Share Option, multiplied by the excess of the average closing price of the Common Stock over the 10 trading days immediately preceding the Payment Date over the exercise price per share of the 1,500,000 Share Option; and
- (ii) the greater of (x) the amount of any net built-in gain (closing price on the date(s) of exercise over exercise price(s)) on any portions of the 1,500,000 Share Option which you exercised prior to the Payment Date and (y) the number of shares that have been issued under the exercised portion of the 1,500,000 Share Option, multiplied by the excess of the average closing price of the Common Stock over the 10 trading days

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immediately preceding the Payment Date over the exercise price per share of the 1,500,000 Share Option.

The Special Cash Bonus will be payable through net exercise of the 1,500,000 Share Option (with the excess of the closing price of the Common Stock on the trading day immediately preceding the Payment Date over the aggregate exercise price for such shares being applied to reduce on a dollar for dollar basis the Special Cash Bonus otherwise payable), and a lump sum cash payment by the Company of the remainder of the Special Cash Bonus. All references to "closing price" in this Agreement shall refer to such price on the applicable day as quoted in the Wall Street Journal.

(e) Rabbi Trust. In the event the cash and cash equivalents held by the Company (determined in accordance with Generally Accepted Accounting Principles) are valued at \$25 million or less, the Company shall immediately contribute \$7,000,000 to a rabbi trust established for your benefit. The rabbi trust shall be in substantially the form of the model rabbi trust prepared by the Internal Revenue Service and shall be trustee by a bank trustee. The Special Cash Bonus shall be the sole benefit payable from such rabbi trust; provided that the Company may, at its sole discretion, pay the Special Cash Bonus from other sources, in which event the assets of the rabbi trust shall revert to the Company. In no event shall the Special Cash Bonus paid to you from the rabbi trust exceed the amounts due under paragraph (d) above after taking into account the net exercise of the 1,500,000 Share Option. The rabbi trust shall terminate following payment of the Special Cash Bonus, and any remainder left in the rabbi trust following payment of the Special Cash Bonus shall revert to the Company.

8. Relocation Assistance. Your primary residence is located in Southern California. You will move your primary residence to the San Francisco Bay Area by July 1, 1999. Until the relocation of your primary residence, the Company will reimburse you for all reasonable travel expenses incurred in commuting from your residence in Southern California to the Company's offices to provide services hereunder, as well as the reasonable costs of maintaining a second residence and a leased car in the San Francisco Bay Area, including up to two trips a month for your family to the Bay Area. The Company will pay for your reasonable moving expenses attributable to the relocation of your primary residence to the San Francisco Bay Area. After you move your residence to the San Francisco Bay Area, the Company shall not require you to relocate your residence from the San Francisco Bay Area without your prior written consent, or from any other area to which you may voluntarily move with the Company's prior written consent during the Term. The Company shall not be required to pay all or

any part of the cost of your new residence in the San Francisco Bay Area. In addition, the Company will pay you a tax gross-up payment in an amount sufficient to ensure that you do not incur any net income tax liability due to the payments described in this Section 8.

9. Employee Benefit Programs. Commencing on the Effective Date, and during the period of your full-time employment, you will be entitled to participate in all Company employee benefit plans and compensation and perquisite programs made available to the Company's executives or salaried employees generally, including the Company's Employee Stock Purchase Plan, 401(k) Plan and Executive Deferred Compensation Plan. You will be entitled to reimbursement of reasonable work-related expenses. You will be entitled to four weeks of paid vacation per year, provided that you will not accrue unused vacation of more

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than eight weeks. You will be paid for unused vacation time.

#### 10. Consequences of Termination of Employment.

(a) Involuntary Termination By Company For Cause. In the event the Company terminates your full-time employment during the term of this Agreement for Cause, you will be entitled to any unpaid salary, bonus and vacation due you pursuant to paragraphs 3, 4 and 9 above through the date of termination and you will be entitled to no other compensation from the Company.

(b) Involuntary Termination (i) By Company Without Cause or (ii) by Constructive Termination - Before Change in Control. In the event either (i) the Company terminates your full-time employment without Cause during the Term and before the consummation of a Change in Control or (ii) your employment is terminated during the Term and before the consummation of a Change in Control by Constructive Termination, you will be entitled to the following:

- (i) the Company will pay you any unpaid salary, bonus and vacation due you pursuant to paragraphs 3, 4 and 9 above through the date of termination. For 12 months thereafter, your base salary and benefits will continue, and each month during that 12-month period you will be paid 1/12th of the maximum (200% of base salary) regular bonus payable under paragraph 4;
- (ii) the 1,500,000 Share Option will be fully vested and exercisable, as set forth in paragraph 6 above;

- (iii) the 3,000,000 Share Option will continue to vest during the 12-month compensation and benefit continuation period, subject to your provision, if requested to do so by the Company, of consulting services to the Company and your agreement to, and compliance with, nonsolicitation and noncompetition agreements in favor of the Company (substantially in the form attached as Exhibit E) during such 12-month period. The 3,000,000 Share Option, in such event shall terminate 90 days after the end of such vesting continuation period; and
- (iv) the Special Cash Bonus will be paid as set forth in paragraph 7 above, provided that the amount of the Special Cash Bonus will be calculated as of the date of termination of your full-time employment and paid three business days after such termination (and such payment date will be deemed the "Payment Date"). The net exercise value of the 1,500,000 Share Option shall, for purposes of determining the amount of Special Cash Bonus payable, if any, be determined based on the closing price of the Common Stock on the trading day immediately preceding the date of termination of your full-time employment.

(c) Involuntary Termination (i) By Company Without Cause or (ii) by Constructive Termination - Upon or After Change in Control. In the event either (i) the Company terminates your employment without Cause during the Term upon or after the consummation of a Change

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in Control or (ii) your employment is terminated during the Term on or after the consummation of a Change in Control of a Constructive Termination, you will be entitled to the following:

- (i) the Company will pay you any unpaid salary, bonus and vacation due you pursuant to paragraphs 3, 4 and 9 above through the date of termination. For 18 months thereafter, your base salary and benefits will continue, and each month during that 18-month period you will be paid 1/12th of the maximum (200% of base salary) regular bonus payable under paragraph 4;
- (ii) the 1,500,000 Share Option will be fully vested and exercisable, as set forth in paragraph 6 above;
- (iii) the 3,000,000 Share Option will continue to vest as follows:

if the termination precedes the second anniversary of the Effective Date, the 3,000,000 Share Option will continue to vest over the 18-month compensation and benefit continuation period, subject to your provision, if requested to do so, of consulting services to the Company and your agreement to, and compliance with, nonsolicitation and noncompetition agreements in favor of the Company (substantially in the form attached as Exhibit E) during the 18-month period. If the termination is on or after the second anniversary of the Effective Date, the 3,000,000 Share Option will continue to vest over the 18-month compensation and benefit continuation period, subject to your provision, if requested to do so, of consulting services to the Company and your agreement to, and compliance with, nonsolicitation and noncompetition agreements in favor of the Company (substantially in the form attached as Exhibit E) during the 18-month period, and any portion of the 3,000,000 Share Option that would not vest during the 18-month continuation period will be fully vested at the date of termination. The 3,000,000 Share Option in either event would terminate 90 days after the end of such vesting continuation period;

- (iv) the Special Cash Bonus will be paid as set forth in paragraph 7 above, provided that the amount of the Special Cash Bonus will be calculated as of the date of termination of your full-time employment and paid three business days after such termination (and such payment date will be deemed the "Payment Date"). The net exercise value of the 1,500,000 Share Option shall, for purposes of determining the amount of Special Cash Bonus payable, if any, be determined based on the closing price of the Common Stock on the trading day immediately preceding the date of termination of your full-time employment; and
- (v) you will be paid an additional payment equal to the excess, if any, of (x) \$10,000,000, over (y) the Special Cash Bonus, plus the total salary and bonus continuation payments payable pursuant to clause (i) of paragraph 10(c), plus the net exercise value of the 3,000,000 Share Option (including any exercised portion thereof). Net exercise value for these purposes will be determined by taking any built-in gain (greater of closing price on the date of exercise or closing price on your termination of full-time employment over exercise price) on any portion of the 3,000,000 Share Option which you exercised prior to the

termination date of your full-time employment, and adding thereto the product of the number of shares of Common Stock that are still subject to the 3,000,000 Share Option times the excess of the closing price of the Common Stock on the last trading day immediately preceding your termination of full-time employment over the exercise price per share of the 3,000,000 Share Option. If the amount referenced in (y) exceeds \$10,000,000, the Company will have no claim to the excess and you shall have no rights to any payments pursuant to this clause (v).

(d) Voluntary Termination, Death or Disability. In the event you terminate your employment with the Company of your own volition (other than a Constructive Termination) or as a result of death or Disability, such termination will have the same consequences as a termination for Cause.

(e) Examples. Examples of the operation of this paragraph 10 and paragraph 7 are attached hereto as Exhibit C.

#### 11. Conditions to Receipt of Payments and Benefits.

(a) Release of Claims. As a condition to the receipt of any the payments and other consideration described in paragraph 10, you must execute and deliver to the Company a full and complete release and covenant not to sue substantially in the form of Exhibit F (the "Release") of all past, present and future claims you may have against the Company or any of its officers, directors, shareholders, employees, consultants and agents arising directly or indirectly from your employment relationship with the Company, this Agreement or any act or omission predating the execution of the Release and thereafter take no action to void or otherwise limit or terminate the Release within any applicable statutory periods providing such rights.

(b) Proprietary Information. In view of your position and access to proprietary information, as a condition to the receipt of payments and other consideration described in this Agreement, during the term of your employment by the Company you will not, without the Company's written consent, directly or indirectly, alone or as a partner, joint venturer, officer, director, employee, consultant, agent or stockholder (other than a less than 5% stockholder of a publicly traded company) (i) engage in any activity which is in competition with the business, the products or services of the Company, (ii) solicit any of the Company's employees, consultants or customers, (iii) hire any of the Company's employees or consultants in an unlawful manner or actively encourage employees or consultants to leave the Company, or (iv) otherwise breach your proprietary information obligations. You agree to execute and comply with the Company's standard form of Proprietary Information and Inventions Agreement, attached as Exhibit D as a condition to receipt of any payments or other consideration under this Agreement.

12. Assignability; Binding Nature. Commencing on the Effective Date, this Agreement will be binding upon you and the Company and your respective successors, heirs, and assigns. This Agreement may not be assigned by you except that your rights to compensation and benefits hereunder, subject to the limitations of this Agreement, may be transferred by will or operation of law. No rights or obligations of the Company under this Agreement may be

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assigned or transferred except by operation of law in the event of a merger or consolidation in which the Company is not the continuing entity, or the sale or liquidation of all or substantially all of the assets of the Company, provided that the assignee or transferee is the successor to all or substantially all of the assets of the Company and assumes the Company's obligations under this Agreement contractually or as a matter of law.

13. Notice. Any notice to be delivered pursuant to this Agreement shall be in writing and shall be deemed delivered upon service, if served personally, or three days after deposit in the United States Mail, if mailed by first class mail, postage prepaid, registered or certified with return receipt requested, addressed to the other party at the address set forth herein, or such other address as may be designated in accordance herewith:

If to you:

Kenneth Potashner  
16452 Avenida de los Olivos  
Rancho Santa Fe, CA 92067

with a copy to his counsel  
at:

Deidra Schneider  
Latham & Watkins  
701 B Street, Suite 2100  
San Diego, CA 92101-8197

If to the Company:

S3 Incorporated  
2801 Mission College Boulevard  
P. O. Box 58058  
Santa Clara, CA

with a copy to its counsel  
at:

Jorge del Calvo, Esq.  
Pillsbury Madison & Sutro LLP  
2550 Hanover Street  
Palo Alto, CA 94304

14. Dispute Resolution. Any disputes between you and the Company, including but not limited to disputes arising out of or related to the Agreement and disputes arising out of or related to the agreements evidencing your Company stock options, shall be resolved by using the following procedures, except that paragraphs (c) and (d) will not be followed in cases where the law specifically forbids the use of arbitration as a final and binding remedy, or where paragraph (d) below specifically allows a different remedy.

(a) The party claiming to be aggrieved shall furnish to the other party a written statement of the grievance identifying any witnesses or documents that support the grievance and the relief requested or proposed.

(b) If the other party does not agree to furnish the relief requested or proposed, or otherwise does not satisfy the demand of the party claiming to be aggrieved, the parties shall submit the dispute to nonbinding mediation before a mediator to be jointly selected by the

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parties. The Company will pay the cost of the mediation.

(c) If the mediation does not produce a resolution of the dispute, the parties agree that the dispute shall be resolved by final and binding arbitration. The parties shall attempt to agree to the identity of an arbitrator, and, if they are unable to do so, they will obtain a list of arbitrators from the Federal Mediation and Conciliation Service and select an arbitrator by striking names from that list. The arbitrator shall have the authority to determine whether the conduct complained of in paragraph (a) violates the rights of the complaining party and, if so, to grant any relief authorized by law; subject to the exclusions of paragraph (d) below. The arbitrator shall not have the authority to modify, change or refuse to enforce the terms of this Agreement.

The hearing shall be transcribed. The Company shall bear the costs of the arbitration if you prevail. If the Company prevails, you will pay half the cost of the arbitration. The prevailing party in the arbitration shall be entitled to recover from the other party his or its reasonable attorney fees and its costs incurred in connection with the arbitration, as determined by the arbitrator.

(d) Arbitration shall be the exclusive final remedy for any dispute between the parties, and the parties agree that no dispute shall be submitted to arbitration where the party claiming to be aggrieved has not complied with the preliminary steps provided for above. The parties agree that the arbitration

award shall be enforceable in any court having jurisdiction to enforce this Agreement, so long as the arbitrator's findings of fact are supported by substantial evidence on the whole and the arbitrator has not made errors of law; provided however, that either party may bring an action, including but not limited to an action for injunctive relief, in a court of competent jurisdiction, regarding or related to matters involving the Company's confidential, proprietary or trade secret information, or regarding or related to inventions that the you may claim to have developed prior to joining the Company or after joining the Company, pursuant to California Labor Code 2870. The parties further agree that for violations of my confidential, proprietary information or trade secret obligations which the parties have elected to submit to arbitration, the Company retains the right to seek preliminary injunctive relief in court in order to preserve the status quo or prevent irreparable injury before the matter can be heard in arbitration.

15. Governing Law. This Agreement will be deemed a contract made under, and for all purposes will be construed in accordance with, the laws of California applicable to contracts between California residents and wholly to be performed in California, notwithstanding California, without regard to California choice of law provisions or principles of conflicts of law.

16. Withholding. Anything to the contrary notwithstanding, following the Effective Date all payments made by the Company hereunder to you or your estate or beneficiaries will be subject to tax withholding pursuant to any applicable laws or regulations. In lieu of withholding, the Company may, in its sole discretion, accept other provision for payment of taxes as required by law, provided it is satisfied that all requirements of law affecting its responsibilities to withhold such taxes have been satisfied.

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17. Entire Agreement. Except as otherwise specifically provided in this Agreement, this Agreement together with all Exhibits thereto, contains all the legally binding understandings and agreements between you and the Company pertaining to the subject matter of this Agreement and supersedes all such agreements, whether oral or in writing, previously entered into between the parties.

18. Miscellaneous. No provision of this Agreement may be amended or waived unless such amendment or waiver is agreed to by you and the Board in writing. No waiver by you or the Company of the breach of any condition or provision of this Agreement will be deemed a waiver of a similar or dissimilar provision or condition at the same or any prior or subsequent time. In the event any portion of this Agreement is determined to be invalid or unenforceable for any reason, the remaining portions will be unaffected thereby and will remain in full force and effect to the fullest extent permitted by law.

The offer made by this letter will terminate if you do not return a signed copy of this letter by \_\_\_\_\_, 1998.

Sincerely,

S3 Incorporated

By

Its

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ACKNOWLEDGED AND AGREED:

/s/ Kenneth Potashner

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Kenneth Potashner

Dated: October 30, 1998

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EXHIBIT C

EXAMPLES

I. \$100,000 LIMITATION ON INCENTIVE STOCK OPTIONS

Internal Revenue Code section 422(d) states that to the extent the aggregate fair market value of an incentive stock option ("ISO") that first becomes exercisable in a calendar year exceeds \$100,000 in a given year, the option will not be an ISO. For this purpose, the fair market value is determined on the date of grant (which, for an ISO, cannot precede the first day of employment).

For example, if the 3,000,000 Share Option is granted on November 2, 1998, and the fair market value of a share of Company common stock on that date is \$3.50, then the portion of the 3,000,000 Share Option that will be an ISO will be as follows:

- \* Of the 750,000 shares vesting on 11/2/99, 28,571 shares (\$100,000 divided by \$3.50) will be ISOs;
- \* No other shares vesting in 1999 will be ISOs;
- \* The first 28,571 shares vesting in each subsequent calendar year will be ISOs.

II. SPECIAL CASH BONUS

Assumptions

1,500,000 Share Option has \$3.00 exercise price  
 Closing price @ 1-year anniversary, and for preceding 10 trading days, is \$4.00  
 Closing price @ 2-year anniversary, and for preceding 10 trading days, is \$5.00  
 Closing price @ 3-year anniversary, and for preceding 10 trading days, is \$6.00

Threshold Conditions to Payment of Special Cash Bonus

- Average closing price over last 10 trading days in 3-year term is less than \$7.67 (\$4.67 plus \$3.00)
- During each and every 10 trading day period that occurs in an open officers trading window, the average closing price is less than \$7.67.
- No hedging transactions
- Employed on a full-time basis @ 3 year anniversary.

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Amount of Special Cash Bonus

Example 1 - No Option Exercise;  
 Special Cash Bonus payable @ 3-year anniversary

$$\begin{array}{r}
 \text{Special Cash Bonus} = \$7,000,000 \\
 \quad - 1,500,000 \times (\$6.00 - \$3.00) \\
 \hline
 = \$2,500,000
 \end{array}$$

Example 2 - No Option Exercise;  
 Terminated Without Cause @ 2-year anniversary  
 Special Cash Bonus payable @ termination

$$\begin{array}{r}
 \text{Special Cash Bonus} = \$7,000,000 \\
 \quad - 1,500,000 \times (\$5.00 - \$3.00)
 \end{array}$$

-----  
= \$4,000,000

Example 3 - Option exercised @ 2-year anniversary for 400,000 Shares;  
Special Cash Bonus payable @ 3-year anniversary

Special Cash Bonus = \$7,000,000  
- 1,100,000 x (\$6.00 - \$3.00)  
- greater of:  
    (i) 400,000 x (\$5.00-\$3.00); or  
    (ii) 400,000 x (\$6.00-\$3.00) - 1,200,000  
-----  
= \$2,500,000

Note that the formula results in the same bonus, whether you exercise or not, unless the closing price is higher at exercise than the closing price at payment of the Special Cash Bonus.

### III. SECTION 7(b) CRITERION

Assume an exercise price per share of \$3.50 per share for the 1,500,000 Share Option. Assume further that during every 10 trading day period occurring during an open trading window, the average closing price per share is less than \$ 8.17 (the sum of \$3.50 and \$4.67). Section 7(b) shall not bar the payment of the Special Cash Bonus.

Assume now the same facts, but during one 10 trading day period occurring during an open trading window, the average closing price is \$8.25. No Special Cash Bonus will be payable.

### IV. SECTION 10(c) (v) PAYMENT

Assumptions 3,000,000 Share Option exercise price is \$3.00  
Total Salary and Bonus Continuation is \$2,250,000  
(18 months @ 500,000 + 200% bonus)

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Example 1: 3,000,000 Share Option is not exercised. Closing price on last trading day preceding termination is \$5.00. At this price, the Special Cash Bonus is approximately \$4,000,000.

The Section 10(c) (v) payment will be:

\$10,000,000  
less \$4,000,000 (option bonus)  
less \$2,250,000 (salary and bonus continuation) [constant]  
less 3,000,000 x (\$5.00 - \$3.00)

-----  
(negative number)

No Section 10(c)(v) payment will be made.

Example 2

- Same facts as 1, except that the closing price is \$6.00, so the Special Cash Bonus will be \$2,500,000.

\$10,000,000  
less 2,500,000  
less 2,250,000  
less 9,000,000

-----  
(negative number)

No Section 10(c)(v) payment will be made.

Example 3:

Same facts as 2, except that the closing price is \$1.00. The Special Cash Bonus will be \$7,000,000.

\$10,000,000  
less \$7,000,000 (option bonus)  
less \$2,250,000 (salary/bonus continuation)  
less 3,000,000x (\$1.00-\$3.00) = 0 (built-in gain)  
-----  
\$750,000

The Section 10(c)(v) payment will be \$750,000.

EXHIBIT D

PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

## EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT is entered into effective as of November 20, 1998 between S3 INCORPORATED, a Delaware corporation (the "Company") and RON YARA ("Mr. Yara").

## RECITALS:

A. Mr. Yara is a member of the S3 Board of Directors.

B. The Company desires to employ Mr. Yara on the terms set forth herein.

The parties hereby agree as follows:

1. Employment. The Company shall employ Mr. Yara [to perform the services as may be reasonably requested of him from time to time by \_\_\_\_\_][as its \_\_\_\_\_], and Mr. Yara accepts such employment.

## 2. Compensation.

(a) For all Mr. Yara's services to be performed by Mr. Yara under this Agreement from Mr. Yara's residence, the Company shall pay Mr. Yara, or cause him to be paid, a salary of not less than \$2,000 per month, payable in accordance with the Company's payroll policy as constituted from time to time. Such salary may be increased by the Board but may not be decreased without Mr. Yara's consent. In addition, should Mr. Yara's duties require him to perform such services away from his residence or in excess of 20 hours in any month, Mr. Yara shall be paid at the rate of \$2,000 per single day, \$3,500 for a consecutive 2-day period and \$7,000 per week for a continuous week for any such services rendered. This compensation shall be in addition to any benefits that accrue to Mr. Yara under any stock option, insurance, or other plan of the Company but shall not be payable for services performed by Mr. Yara in his capacity as a member of the Board. Mr. Yara shall not participate in the Company's executive bonus plan. The Board, however, in its sole discretion, may award Mr. Yara a bonus for services rendered.

(b) Continued Vesting Under Options. Vesting under all of Mr. Yara's option agreements with the Company shall continue during the term of this Agreement. During the term of this Agreement, Mr. Yara shall continue to have the status as an employee Director and shall not be entitled to receive cash compensation as a Director, other than reimbursement of expenses.

(c) Reimbursement of Expenses. The Company shall pay or reimburse Mr. Yara for all reasonable travel and other expenses incurred or paid by Mr. Yara

in connection with the performance of his duties under this Agreement; such payment or reimbursement shall be in accordance with the Company's reimbursement policy as established from time to time by the

-1-

2

Company's Board or, in absence of any such policy, in accordance with comparable standards used in the conduct of the Company's business prior to the date hereof.

3. Benefits. Mr. Yara shall be entitled to participate in any plan or arrangement for, or to receive any other employment benefits normally available to, part-time employees of the Company, on the same basis that such participation or such benefits are normally granted to such other employees.

4. Option Grants.

(a) Mr. Yara shall receive, if he is then serving as a Director, an NSO to purchase 20,000 shares at each regular annual meeting of the Company's shareholders at which he is re-elected as a director. These NSOs will have an exercise price equal to one hundred percent (100%) of the fair market value of a share of the Company's common stock on the date of grant and shall vest and become exercisable at the rate of 25% on each one year anniversary of the date of grant. All such options granted shall become fully exercisable upon Mr. Yara's death, disability or a "change of control" as defined in the 1989 Stock Plan. All such options shall expire on the earliest of (b) the tenth anniversary of the date of grant, (c) ninety (90) days after termination of Mr. Yara's service as an employee, consultant or director, or (d) twelve (12) months after termination of such service on account of death, disability or retirement as a director or employee after age 60.

5. Confidentiality. The obligations of Mr. Yara under the Mr. Yara's Proprietary Information and Inventions Agreement or any similar agreement he has entered into with the Company shall remain in full force and effect during the term of employment hereunder.

6. Termination. This Agreement, and Mr. Yara's employment hereunder, may be terminated by either party at any time, with or without cause. Any termination by the Company must be approved by a majority vote by the Board (excluding for purposes of such vote, Mr. Yara if he is a member of the Board at the time of such vote).

7. Term. This Agreement shall continue indefinitely unless terminated in accordance with paragraph 6 above.

8. No Assurance of Continued Service as Member of the Board of Directors. Nothing herein shall assure Mr. Yara of any rights to continue as a

3

9. Miscellaneous. This Agreement shall be binding upon, and inure to the benefit of, Mr. Yara and his heirs, personal representatives, executors and administrators, and shall inure to the benefit of and be binding upon the Company, its successors and assigns. This Agreement may be modified or amended only by written consent of both parties. This Agreement shall be governed and enforced in accordance with the laws of the State of California applicable to contracts between California residents and wholly to be performed in California, notwithstanding California choice of law rules. This instrument contains the entire agreement of the parties relating to the subject matter hereof, and supersedes all prior and contemporaneous negotiations, correspondence, understandings and agreements of the parties relating to the subject matter hereof. In the event that any provision of this Agreement is held to be invalid or unenforceable for any reason, the Company and Mr. Yara shall replace such provision with a valid provision which most closely approximates the intent and economic effect of the invalid or unenforceable provision, and the remaining provisions of the Agreement shall continue in full force and effect. The waiver by any party of any provision of this Agreement or any breach of this Agreement shall not operate or be interpreted as a waiver of any other provision or breach existing then or arising in the future. Any subject headings of paragraphs of this Agreement are included for convenience only and shall not affect the construction or interpretation of any of its provisions.

IN WITNESS WHEREOF, the undersigned have executed this Agreement as of the date first written above.

S3 INCORPORATED

By           /s/ Kenneth Potashner  
-----  
Title       Chief Executive Officer  
-----

                  /s/ Ron Yara  
-----  
                                  Ron Yara



S3 INCORPORATED  
2801 Mission College Blvd.  
P.O. Box 58058  
Santa Clara, CA 95052-8058

[S3 Incorporated Logo]

September 22, 1998

TO: Paul Franklin

Re: Agreement Regarding Severance

Dear Paul,

This letter agreement sets forth the terms and conditions of severance that will be paid to you in the event your employment with S3 Incorporated (the "Company") is involuntarily terminated other than for Cause.

By signing below, you and the Company agree as follows:

1. Severance Payment. Subject to the release requirement of paragraph 2, if your employment is terminated at the behest of the company other than for Cause, you will be paid a lump sum payment equal to six months of your base salary, plus one month of base salary for every full year of your service to the Company. In addition, the term for exercise of your outstanding options will be extended until six months after your termination (although you will not continue to vest after your termination). You should be aware that the extension of your option exercise term will cause an incentive stock option to become a nonstatutory stock option, which means that you could be taxed at exercise. Please advise the Company if you have any concerns about this consequence before signing below. Your severance will be reduced for applicable withholding.

2. Release Requirement. No severance will be paid, and your option exercise term will not be extended, unless you execute and deliver to the Company a full and complete release and covenant not to sue (prepared by, and in form and substance acceptable to, the Company (the "Release") of all past, present and future claims you may have against the Company or any of its officers, directors, shareholders, employees, consultants and agents arising directly or indirectly from your employment relationship with the Company, this letter agreement or any act or omission predating the execution of the Release and thereafter take no action to void or otherwise limit or terminate the Release within any applicable statutory periods providing such rights.

3. Cause. For purposes of this letter agreement, "Cause" means: (i)

failure to substantially perform the duties and obligations of your employment, (ii) misconduct which could reasonably be expected to cause substantial injury to the Company or any of its affiliates, (iii) material breach of any agreement between you and the Company or any of its affiliates, or (iv) violation or breach of any obligation under any confidentiality, assignment of inventions, or non-solicitation agreement between you and the Company.

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Paul Franklin  
September 22, 1998  
Page 2

4. Adjustments to Minimize Taxes Under Golden Parachute Rules. In the event that any severance payments hereunder are determined to be "excess parachute payments" pursuant to Section 280G of the Internal Revenue Code of 1986, as amended, such severance payments shall be reduced to the extent necessary to maximize your after-tax income.

5. Binding On Successors. This letter agreement will be binding upon you and any person who is a successor by merger, acquisition, consolidation or otherwise to the business formerly carried on by the Company, or an affiliate of any such person, and becomes your employer by reason of (or as the direct result of) any direct or indirect sale or other disposition of the Company or substantially all of the assets of the business currently carried on by the Company, without regard to whether or not such person actively adopts this letter agreement.

6. Nonassignability. You may not sell, assign or otherwise transfer any right or interest you may have under this letter agreement other than by will or by operation of law.

7. Dispute Resolution. You and the Company agree to be bound by the Dispute Resolution procedures attached hereto.

8. Severability. If any provision of this letter agreement is held invalid or unenforceable, its invalidity or unenforceability will not affect any other provision of the letter agreement, and the letter agreement will be construed and enforced as if such provision had not been included.

9. Governing Law. This letter agreement will be deemed a contract made under, and for all purposes shall be construed in accordance with, the laws of California (without regard to its choice of law provisions).

Sincerely,

/s/ Terry Holdt

-----  
Terry Holdt  
President, CEO and Chairman  
S3 Incorporated  
Dated: September 22, 1998

ACKNOWLEDGED AND AGREED

/s/ Paul Franklin

-----  
Dated: September 22, 1998

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#### DISPUTE RESOLUTION

Any disputes between you and the Company, including but not limited to disputes arising out of or related to the letter agreement shall be resolved by using the following procedures, except that paragraphs (c) and (d) will not be followed in cases where the law specifically forbids the use of arbitration as a final and binding remedy, or where paragraph (d) below specifically allows a different remedy.

(a) The party claiming to be aggrieved shall furnish to the other party a written statement of the grievance identifying any witnesses or documents that support the grievance and the relief requested or proposed.

(b) If the other party does not agree to furnish the relief requested or proposed, or otherwise does not satisfy the demand of the party claiming to be aggrieved, the parties shall submit the dispute to nonbinding mediation before a mediator to be jointly selected by the parties. The Company will pay the cost of the mediation.

(c) If the mediation does not produce a resolution of the dispute, the parties agree that the dispute shall be resolved by final and binding arbitration. The parties shall attempt to agree to the identity of an arbitrator, and, if they are unable to do so, they will obtain a list of arbitrators from the Federal Mediation and Conciliation Service and select an arbitrator by striking names from that list. The arbitrator shall have the authority to determine whether the conduct complained of in paragraph (a) violates the rights of the complaining party and, if so, to grant any relief authorized by law; subject to the exclusions of paragraph (d) below. The arbitrator shall not have the authority to modify, change or refuse to enforce the terms of this letter agreement.

The hearing shall be transcribed. The Company shall bear the costs of the arbitration if you prevail. If the Company prevails, you will pay half the cost of the arbitration or \$500, whichever is less. Each party shall be responsible for paying its own attorneys' fees, unless the arbitrator orders otherwise, pursuant to applicable law.

(d) Arbitration shall be the exclusive final remedy for any dispute between the parties, and the parties agree that no dispute shall be submitted to arbitration where the party claiming to be aggrieved has not complied with the preliminary steps provided for above. The parties agree that the arbitration award shall be enforceable in any court having jurisdiction to enforce this letter agreement, so long as the arbitrator's findings of fact are supported by substantial evidence on the whole and the arbitrator has not made errors of law; provided however, that either party may bring an action, including but not limited to an action for injunctive relief, in a court of competent jurisdiction, regarding or related to matters involving the Company's confidential, proprietary or trade secret information, or regarding or related to inventions that you may claim to have developed prior to joining the Company or after joining the Company, pursuant to California Labor Code 2870. The parties further agree that for violations of any confidential, proprietary information or trade secret obligations which the parties have elected to submit to arbitration, the Company retains the right to seek preliminary injunctive relief in court in order to preserve the status quo or prevent irreparable injury before the matter can be heard in arbitration.

S3 INCORPORATED  
2801 Mission College Blvd.  
P.O. Box 58058  
Santa Clara, CA 95052-8058

[S3 Incorporated Logo]

September 22, 1998

TO: Walt Amaral

Re: Agreement Regarding Severance

Dear Walt,

This letter agreement sets forth the terms and conditions of severance that will be paid to you in the event your employment with S3 Incorporated (the "Company") is involuntarily terminated other than for Cause.

By signing below, you and the Company agree as follows:

1. Severance Payment. Subject to the release requirement of paragraph 2, if your employment is terminated at the behest of the company other than for Cause, you will be paid a lump sum payment equal to six months of your base salary, plus one month of base salary for every full year of your service to the Company. In addition, the term for exercise of your outstanding options will be extended until six months after your termination (although you will not continue to vest after your termination). You should be aware that the extension of your option exercise term will cause an incentive stock option to become a nonstatutory stock option, which means that you could be taxed at exercise. Please advise the Company if you have any concerns about this consequence before signing below. Your severance will be reduced for applicable withholding.

2. Release Requirement. No severance will be paid, and your option exercise term will not be extended, unless you execute and deliver to the Company a full and complete release and covenant not to sue (prepared by, and in form and substance acceptable to, the Company (the "Release") of all past, present and future claims you may have against the Company or any of its officers, directors, shareholders, employees, consultants and agents arising directly or indirectly from your employment relationship with the Company, this letter agreement or any act or omission predating the execution of the Release and thereafter take no action to void or otherwise limit or terminate the Release within any applicable statutory periods providing such rights.

3. Cause. For purposes of this letter agreement, "Cause" means: (i) failure to substantially perform the duties and obligations of your employment, (ii) misconduct which could reasonably be expected to cause substantial injury

to the Company or any of its affiliates, (iii) material breach of any agreement between you and the Company or any of its affiliates, or (iv) violation or breach of any obligation under any confidentiality, assignment of inventions, or non-solicitation agreement between you and the Company.

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Walt Amaral  
September 22, 1998  
Page 2

4. Adjustments to Minimize Taxes Under Golden Parachute Rules. In the event that any severance payments hereunder are determined to be "excess parachute payments" pursuant to Section 280G of the Internal Revenue Code of 1986, as amended, such severance payments shall be reduced to the extent necessary to maximize your after-tax income.

5. Binding On Successors. This letter agreement will be binding upon you and any person who is a successor by merger, acquisition, consolidation or otherwise to the business formerly carried on by the Company, or an affiliate of any such person, and becomes your employer by reason of (or as the direct result of) any direct or indirect sale or other disposition of the Company or substantially all of the assets of the business currently carried on by the Company, without regard to whether or not such person actively adopts this letter agreement.

6. Nonassignability. You may not sell, assign or otherwise transfer any right or interest you may have under this letter agreement other than by will or by operation of law.

7. Dispute Resolution. You and the Company agree to be bound by the Dispute Resolution procedures attached hereto.

8. Severability. If any provision of this letter agreement is held invalid or unenforceable, its invalidity or unenforceability will not affect any other provision of the letter agreement, and the letter agreement will be construed and enforced as if such provision had not been included.

9. Governing Law. This letter agreement will be deemed a contract made under, and for all purposes shall be construed in accordance with, the laws of California (without regard to its choice of law provisions).

Sincerely,

/s/ Terry Holdt  
-----

Terry Holdt  
President, CEO and Chairman  
S3 Incorporated  
Dated: September 22, 1998

ACKNOWLEDGED AND AGREED

/s/ Walt Amaral  
-----

Dated: September 30, 1998

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#### DISPUTE RESOLUTION

Any disputes between you and the Company, including but not limited to disputes arising out of or related to the letter agreement shall be resolved by using the following procedures, except that paragraphs (c) and (d) will not be followed in cases where the law specifically forbids the use of arbitration as a final and binding remedy, or where paragraph (d) below specifically allows a different remedy.

(a) The party claiming to be aggrieved shall furnish to the other party a written statement of the grievance identifying any witnesses or documents that support the grievance and the relief requested or proposed.

(b) If the other party does not agree to furnish the relief requested or proposed, or otherwise does not satisfy the demand of the party claiming to be aggrieved, the parties shall submit the dispute to nonbinding mediation before a mediator to be jointly selected by the parties. The Company will pay the cost of the mediation.

(c) If the mediation does not produce a resolution of the dispute, the parties agree that the dispute shall be resolved by final and binding arbitration. The parties shall attempt to agree to the identity of an arbitrator, and, if they are unable to do so, they will obtain a list of arbitrators from the Federal Mediation and Conciliation Service and select an arbitrator by striking names from that list. The arbitrator shall have the authority to determine whether the conduct complained of in paragraph (a) violates the rights of the complaining party and, if so, to grant any relief authorized by law; subject to the exclusions of paragraph (d) below. The arbitrator shall not have the authority to modify, change or refuse to enforce the terms of this letter agreement.

The hearing shall be transcribed. The Company shall bear the costs of the arbitration if you prevail. If the Company prevails, you will pay half the cost

of the arbitration or \$500, whichever is less. Each party shall be responsible for paying its own attorneys' fees, unless the arbitrator orders otherwise, pursuant to applicable law.

(d) Arbitration shall be the exclusive final remedy for any dispute between the parties, and the parties agree that no dispute shall be submitted to arbitration where the party claiming to be aggrieved has not complied with the preliminary steps provided for above. The parties agree that the arbitration award shall be enforceable in any court having jurisdiction to enforce this letter agreement, so long as the arbitrator's findings of fact are supported by substantial evidence on the whole and the arbitrator has not made errors of law; provided however, that either party may bring an action, including but not limited to an action for injunctive relief, in a court of competent jurisdiction, regarding or related to matters involving the Company's confidential, proprietary or trade secret information, or regarding or related to inventions that you may claim to have developed prior to joining the Company or after joining the Company, pursuant to California Labor Code 2870. The parties further agree that for violations of any confidential, proprietary information or trade secret obligations which the parties have elected to submit to arbitration, the Company retains the right to seek preliminary injunctive relief in court in order to preserve the status quo or prevent irreparable injury before the matter can be heard in arbitration.

S3 INCORPORATED  
2801 Mission College Blvd.  
P.O. Box 58058  
Santa Clara, CA 95052-8058

[S3 Incorporated Logo]

September 22, 1998

TO: Dan Karr

Re: Agreement Regarding Severance

Dear Dan,

This letter agreement sets forth the terms and conditions of severance that will be paid to you in the event your employment with S3 Incorporated (the "Company") is involuntarily terminated other than for Cause.

By signing below, you and the Company agree as follows:

1. Severance Payment. Subject to the release requirement of paragraph 2, if your employment is terminated at the behest of the company other than for Cause, you will be paid a lump sum payment equal to six months of your base salary, plus one month of base salary for every full year of your service to the Company. In addition, the term for exercise of your outstanding options will be extended until six months after your termination (although you will not continue to vest after your termination). You should be aware that the extension of your option exercise term will cause an incentive stock option to become a nonstatutory stock option, which means that you could be taxed at exercise. Please advise the Company if you have any concerns about this consequence before signing below. Your severance will be reduced for applicable withholding.

2. Release Requirement. No severance will be paid, and your option exercise term will not be extended, unless you execute and deliver to the Company a full and complete release and covenant not to sue (prepared by, and in form and substance acceptable to, the Company (the "Release") of all past, present and future claims you may have against the Company or any of its officers, directors, shareholders, employees, consultants and agents arising directly or indirectly from your employment relationship with the Company, this letter agreement or any act or omission predating the execution of the Release and thereafter take no action to void or otherwise limit or terminate the Release within any applicable statutory periods providing such rights.

3. Cause. For purposes of this letter agreement, "Cause" means: (i)

failure to substantially perform the duties and obligations of your employment, (ii) misconduct which could reasonably be expected to cause substantial injury to the Company or any of its affiliates, (iii) material breach of any agreement between you and the Company or any of its affiliates, or (iv) violation or breach of any obligation under any confidentiality, assignment of inventions, or non-solicitation agreement between you and the Company.

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Dan Karr  
September 22, 1998  
Page 2

4. Adjustments to Minimize Taxes Under Golden Parachute Rules. In the event that any severance payments hereunder are determined to be "excess parachute payments" pursuant to Section 280G of the Internal Revenue Code of 1986, as amended, such severance payments shall be reduced to the extent necessary to maximize your after-tax income.

5. Binding On Successors. This letter agreement will be binding upon you and any person who is a successor by merger, acquisition, consolidation or otherwise to the business formerly carried on by the Company, or an affiliate of any such person, and becomes your employer by reason of (or as the direct result of) any direct or indirect sale or other disposition of the Company or substantially all of the assets of the business currently carried on by the Company, without regard to whether or not such person actively adopts this letter agreement.

6. Nonassignability. You may not sell, assign or otherwise transfer any right or interest you may have under this letter agreement other than by will or by operation of law.

7. Dispute Resolution. You and the Company agree to be bound by the Dispute Resolution procedures attached hereto.

8. Severability. If any provision of this letter agreement is held invalid or unenforceable, its invalidity or unenforceability will not affect any other provision of the letter agreement, and the letter agreement will be construed and enforced as if such provision had not been included.

9. Governing Law. This letter agreement will be deemed a contract made under, and for all purposes shall be construed in accordance with, the laws of California (without regard to its choice of law provisions).

Sincerely,

/s/ Terry Holdt  
-----

Terry Holdt  
President, CEO and Chairman  
S3 Incorporated  
Dated: September 22, 1998

ACKNOWLEDGED AND AGREED

/s/ Dan Karr  
-----

Dated: October 29, 1998

3

#### DISPUTE RESOLUTION

Any disputes between you and the Company, including but not limited to disputes arising out of or related to the letter agreement shall be resolved by using the following procedures, except that paragraphs (c) and (d) will not be followed in cases where the law specifically forbids the use of arbitration as a final and binding remedy, or where paragraph (d) below specifically allows a different remedy.

(a) The party claiming to be aggrieved shall furnish to the other party a written statement of the grievance identifying any witnesses or documents that support the grievance and the relief requested or proposed.

(b) If the other party does not agree to furnish the relief requested or proposed, or otherwise does not satisfy the demand of the party claiming to be aggrieved, the parties shall submit the dispute to nonbinding mediation before a mediator to be jointly selected by the parties. The Company will pay the cost of the mediation.

(c) If the mediation does not produce a resolution of the dispute, the parties agree that the dispute shall be resolved by final and binding arbitration. The parties shall attempt to agree to the identity of an arbitrator, and, if they are unable to do so, they will obtain a list of arbitrators from the Federal Mediation and Conciliation Service and select an arbitrator by striking names from that list. The arbitrator shall have the authority to determine whether the conduct complained of in paragraph (a) violates the rights of the complaining party and, if so, to grant any relief authorized by law; subject to the exclusions of paragraph (d) below. The arbitrator shall not have the authority to modify, change or refuse to enforce the terms of this letter agreement.

The hearing shall be transcribed. The Company shall bear the costs of the arbitration if you prevail. If the Company prevails, you will pay half the cost

of the arbitration or \$500, whichever is less. Each party shall be responsible for paying its own attorneys' fees, unless the arbitrator orders otherwise, pursuant to applicable law.

(d) Arbitration shall be the exclusive final remedy for any dispute between the parties, and the parties agree that no dispute shall be submitted to arbitration where the party claiming to be aggrieved has not complied with the preliminary steps provided for above. The parties agree that the arbitration award shall be enforceable in any court having jurisdiction to enforce this letter agreement, so long as the arbitrator's findings of fact are supported by substantial evidence on the whole and the arbitrator has not made errors of law; provided however, that either party may bring an action, including but not limited to an action for injunctive relief, in a court of competent jurisdiction, regarding or related to matters involving the Company's confidential, proprietary or trade secret information, or regarding or related to inventions that you may claim to have developed prior to joining the Company or after joining the Company, pursuant to California Labor Code 2870. The parties further agree that for violations of any confidential, proprietary information or trade secret obligations which the parties have elected to submit to arbitration, the Company retains the right to seek preliminary injunctive relief in court in order to preserve the status quo or prevent irreparable injury before the matter can be heard in arbitration.

## EXHIBIT 12.1

STATEMENT OF COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES  
YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996  
(IN THOUSANDS, EXCEPT RATIOS)

<TABLE>  
<CAPTION>

	1998 ----- <C>	1997 ----- <C>	1996 ----- <C>
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Income (loss) before income taxes and equity in net income of joint venture	\$ (142,629)	\$ (18,631)	\$ 58,923
Add fixed charges	8,256	8,692	2,598
	-----	-----	-----
Earnings (as defined)	\$ (134,373)	\$ (9,939)	\$ 61,521
	=====	=====	=====
Fixed Charges:			
Interest expense	\$ 6,235	\$ 6,477	\$ 1,971
Amortization of debt issuance costs	487	488	132
Estimated interest component of rent expense	1,534	1,727	495
	-----	-----	-----
Total fixed charges	\$ 8,256	\$ 8,692	\$ 2,598
	=====	=====	=====
Ratio of earnings to fixed charges	--	--	23.68
	=====	=====	=====

</TABLE>

Earnings were insufficient to cover fixed charges in the years ended December 31, 1998 and 1997, as evidenced by the less than 1:1 coverage ratio. Additional earnings of \$142.6 million and \$18.6 million were necessary to provide a 1:1 coverage ratio for December 31, 1998 and 1997, respectively.

S3 INCORPORATED  
SUBSIDIARIES OF REGISTRANT

Subsidiary

S3 International Limited (Bermuda Corporation)

S3 Europe Limited (United Kingdom Corporation)

S3 Japan K.K. (Japan Corporation)

S3 Asia Pacific Limited (Hong Kong Corporation)

S3 Singapore Pte Ltd (Singapore Corporation)

## CONSENT OF ERNST &amp; YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-71869) pertaining to the 1989 Stock Plan of S3, Inc. and Registration Statement (Form S-3 No. 333-17519) filed in conjunction with the Company's issuance of convertible subordinated notes and in the related Prospectuses of our report dated January 21, 1999, with respect to the consolidated financial statements and schedule of S3, Inc. included in this Annual Report (Form 10-K) for the year ended December 31, 1998.

San Jose, California  
March 26, 1999

## CONSENT OF DELOITTE AND TOUCHE LLP

We consent to the incorporation by reference in the Registration Statements No. 33-60666, 33-82280, 33-89388, 33-65186, 33-92372, 33-96030, 33-33726, 333-04439, 333-16067, 333-16211, 333-21573, 333-23819, 333-59799, 333-48189 and 333-71869 of S3 Incorporated on Form S-8 and No. 333-17519 on Form S-3 of our report dated January 23, 1998, appearing in the Annual Report on Form 10-K of S3 Incorporated for the year ended December 31, 1998.

DELOITTE & TOUCHE LLP

San Jose, California  
March 26, 1999

[PRICEWATERHOUSECOOPERS LETTERHEAD]

CONSENT OF INDEPENDENT ACCOUNTANTS

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 33-98402 and No. 333-13461) of S3 Incorporated of our report dated January 22, 1999 appearing in this Annual Report on Form 10-K for the years ended December 31, 1998 and 1997.

/s/ PRICEWATERHOUSECOOPERS  
-----

PricewaterhouseCoopers

Hsinchu, Taiwan R.O.C.

February 24, 1999

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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM S3 INCORPORATED CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 1998 AND CONSOLIDATED STATEMENT OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 1998 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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