esmertec

Half Year Report 2006

DUEBENDORF, Switzerland

Contents:

Figures at a Glance

6 month 2006 key figures (US$ '000s)	**2005**	**2006**
Revenue	20,076	9,625
Gross profit	13,802	2,123
in % of revenue	68.75%	22.06%
OPEX*	13,307	18,048
in % of revenue	66.28%	187.51%
EBITA*	3,233	(12,288)
in % of revenue	16.10%	(127.67%)
Adjusted operating profit/(loss)*	495	(15,925)
in % of sales	2.47%	(165.45%)
Operating loss	(1,390)	(34,170)
in % of sales	(6.92%)	(355.01%)
Net loss*	(87)	(16,936)
in % of sales	(0.43%)	(175.96%)

* Excluding bad debt expense, restructuring costs and impairment of intangible assets

Dear Shareholders,

A new chapter began at Esmertec™ with the Board of Directors' appointment of Jean-Claude Martinez as Chief Executive Officer (CEO) in May 2006. The Board was also pleased to announce on August, 30, that Ruedi Noser has accepted the Board of Directors' nomination as Chairman candidate. Mr. Noser is co-founder and Chairman of Noser Group and has over 20 years of experience in the telecommunications industry. He will stand for election as a director at an extraordinary shareholder meeting planned for November 23, 2006.

The first half of 2006 (1H2006) proved to be a challenging phase for Esmertec. Let us summarize some of the key events that took place.

At the beginning of February 2006, Esmertec acquired Cellicium™ S.A. This was an important acquisition to provide Esmertec with reliable and already commercially implemented products for the planned mobile operator business. In addition, Esmertec took a controlling investment in ESLab™, in the Company's Korean service partner with expertise in integrating software in devices, and a minority interest in Javaground™, a company which has developed a software tool that enables content like games to be easily integrated in multiple devices.

We made some significant changes in the senior management team in the first half of the year. We recruited Georges Boulloy, our Chief Product Officer, and reorganized the R&D department along product lines; with this reorganization, Anne-Marie Larkin, Chief Technology Officer, left the Company. We hired Jean-Luc Gianduzzo, Executive Vice President of Global Services, to focus on improving profitability in services. Based on the outlook of company performance in 1H2006, both Billy Crotty, Executive VP Sales and Services, and Chairman and CEO Alain Blancquart left the Company.

Changes in the mobile handset market significantly impacted Esmertec's first half years' revenue. As a result, Jean-Claude led the management team to implement organizational and cost-cutting measures, which were announced on July 3, 2006. Specifically, we reduced our operations in Japan by more than 50%, closed down our OSVM™ R&D center in Denmark, and organized our sales and services team into two groups to allow each group to focus on its core competencies.

Management also focused in solidifying the Company's relationships with customers through a program of increased personal contacts and meetings, and we are pleased to have achieved US$ 9.6 million in revenue for the first six months of 2006, exceeding our expectations at the end of May 2006.

Another key activity in 1H2006 was the building up of our second business segment – the Mobile Operator Segment. Esmertec's historical activity has been focused primarily of our Jbed™ Java™ Virtual Machine and related products and services. With the second business segment, Esmertec moves up the value chain in the telecommunications industry, enabling us to better understand mobile operators' needs, which are strongly linked to the software requirements of handset manufacturers.

In the Mobile and Multimedia Devices Segment, we have two product lines: (1) products for mobile devices such as phones and personal digital assistants, and (2) products for home multimedia devices such as set-top boxes, interactive televisions and Blu-ray Disc™ players.

The mobile devices product line continues to be Esmertec's major revenue contributor, with Esmertec signing a major renewal agreement with a leading handset manufacturer in 1H2006. For the same period, the number of devices shipped by customers grew by over 18 million units, an increase of 94% compared to first half of 2005. This brings the cumulative total of devices shipped by customers with Esmertec's software to more than 58 million devices in over 190 models.

Java technology is increasingly being selected as the interactivity-enabling standard for home multimedia products by industry associations such as the Blu-ray Disc™ Association. With this development, Esmertec has signed an agreement with Pioneer Corporation in 1H2006 to integrate Esmertec's Jbed software in Pioneer's Blu-ray Disc players, which are said to replace DVD players in home entertainment.

In the Mobile Operators Segment, we won five new customers in 1H2006, bringing the total number of mobile operator customers to 15. One of mobile operators' challenges today is finding services that can differentiate them from their competitors. Esmertec's USSD Browsing solution is designed to enable operators to save cost and offer better customer care. The number of subscribers with access to our USSD browsing solution grows steadily and as of today, our customers have a cumulated subscriber base of over 40 million.

Let us now provide you the financial summary for the first six months of 2006.

New Segment reporting

We have changed our segment reporting to reflect the evolution of the Group following the creation of the Mobile Operator Segment at the beginning of the year. The Mobile Operator Segment reflects principally the results of Cellicium S.A. since its acquisition by Esmertec in February 2006. Esmertec's historical activity has been based primarily on the sale of the Jbed Java Virtual Machine and related products and services. This is reflected in the Mobile and Multimedia Devices Segment and is comparable in scope to the historical results for 1H2005.

In US$ millions, except unit shipments	**Esmertec Group 1H2005**	**Mobile & Multimedia Devices Segment 1H2006**	**Mobile Operator Segment 1H2006**	**Esmertec Group 1H2006**
Revenues	20.1	6.3	3.3	9.6
Gross profit	13.8	0.0	2.1	2.1
Restructuring expense	0	(1.7)	0	(1.7)
Impairment loss on intangible assets	0	(15.6)	0	(15.6)
Bad debt expense	(1.9)	(0.9)	0	(0.9)
Other operating expenses, including amortization	(13.3)	(15.9)	(2.1)	(18.0)
Earnings before interest, taxes, amortization/impairment (EBITA)	1.3	(15.7)	0.8	(14.9)
Operating income/(loss)	(1.4)	(34.2)	0.0	(34.2)
Net loss attributable to Esmertec AG shareholders	(1.9)			(34.2)

All figures are unaudited and reported in accordance with International Financial Reporting Standards (IFRS). Condensed and consolidated financial tables are provided at the end of this release.

Revenues

1H2006 revenues for the Group totaled US$ 9.6 million, a decrease of 52% compared to 1H2005. First half-year revenues of the Mobile and Multimedia Devices Segment, which is comparable to Esmertec Group's revenues in 2005, totaled US$ 6.3 million, a 69% decrease from Esmertec Group revenues in 1H2005. This decrease in the Mobile and Multimedia Devices Segment reflects: (1) a combination of market and customer-specific factors in 1H2006 which led to delays or reductions in committed volume contracts, (2) deferral of revenue recognition on contracts with smaller customers, and (3) that several large contracts included in 1H2005 revenues are not expected to be renewed before 2H2006 or 2007. 1H2006 revenues for the newly formed Mobile Operator Segment reflect Cellicium's sales since the acquisition in February 2006.

Gross margin

Gross margin for the consolidated business was 22.1% of revenues in 1H2006 compared to 68.6% in 1H2005. Gross margin for the Mobile and Multimedia Device Segment was slightly above break-even in 1H2006 due to a US$ 2.3 million loss on services, offsetting a US$ 2.3 million (89.2%) gross profit on licenses. The services loss was due primarily to cost overruns in executing customer projects in Japan and a number of evaluation services performed as part of pre-sales efforts. Gross margin in the Mobile Operator Segment was 63.6%.

Operating expenses

Total operating expenses in 1H2006 were US$ 36.3 million compared to US$ 15.2 million in 1H2005, reflecting (1) the acquisition of Cellicium S.A. in February 2006, (2) the full impact of the ramp-up of operations in China which were only partially felt in 1H2005, and (3) the effects of bad debt expense, restructuring costs and non-cash impairment losses on intangible assets.

Bad debt expense of US$ 0.9 million in 1H2006 (1H2005: US$ 1.9 million) reflects a newly-identified customer risk in the Americas as well as additional general provision for risk in Asia. Issues related to certain Chinese customers transferred from CoreTek led Esmertec to negotiate a reduction of the final payment due to CoreTek during 1H2006. The US$ 0.5 million payment reduction was recorded against goodwill on the balance sheet and had no impact on the statement of operations.

As a result of the significant decrease in 1H2006 revenues, Esmertec implemented a number of measures to adjust the Company cost structure and to redeploy resources. The OSVM research center in Denmark was closed, the Japanese sales and support operations were substantially reduced and a number of middle management positions were eliminated. The cost of these measures was US$ 1.7 million. Beginning in the fourth quarter of 2006, the full impact of savings of approximately US$ 2 million per quarter will be felt, a portion of which will be reflected as a reduction in cost of services.

The changes in expectations for revenues from existing products in the Mobile and Multimedia Devices Segment, and the changes in Group structure, also led to a reassessment of the continuing value of intangible assets. Consequently, impairment losses have been recorded in 1H2006 related to OSVM (US$ 3.2 million) and Japan (US$ 9.3 million), as well as acquired and internally developed technology costs (US$ 3.1 million).

Financial expense, net

The net financial expense of US$ 2.5 million for 1H2006 (US$ 0.3 million in 1H2005) reflects interest expense of US$ 1.8 million (US$ 1.5 million in 1H2005) and net foreign exchange loss of US$ 1.0 million (net foreign exchange gain of US$ 1.7 million in 1H2005). The foreign exchange result is driven primarily by the change in value of the US dollar, the currency used in most of our contracts and for valuation of accounts receivable, against the Swiss franc, the functional currency of Esmertec AG.

Income tax expense (benefit)

The net tax benefit of US$ 1.4 million in 1H2006 reflects the effect of the reversal of net deferred tax liabilities related to the impairment of amortizable intangible assets. Net tax expense in 1H2005 was US$ 0.2 million and reflected principally withholding taxes accrued on license revenue.

Net loss

Net loss attributable to the equity holders of Esmertec AG was US$ 34.2 million (US$ 2.10 per share) for 1H2006. Net loss attributable to the equity holders of Esmertec AG in 1H2005 was US$ 1.9 million (US$ 0.18 per share).

Balance sheet

Esmertec's cash and short-term investments position was US$ 25.3 million at June 30, 2006, decreasing from US$ 55 million on December 31, 2005. This reduction reflects the US$ 11.8 million net cash outflow related to the acquisition of Cellicium S.A., the final US$ 2.5 million payment for the acquisition of CoreTek (China), US$ 1 million in investments in and loans to Javaground and ESLabs, and cash used in operations. Cash collections from customers in 1H2006 totaled US$ 13.4 million, in excess of revenues due to collections on contracts executed and recognized in prior periods.

Intangibles assets increased from US$ 31.3 million at December 31, 2005, to US$ 40.0 million at June 30, 2006, reflecting intangible assets arising primarily from the acquisition of Cellicium S.A. (US$ 24.1 million) and ESLabs (US$ 0.3 million), offset by the US$ 15.6 million impairment.

Strategic Focus and Outlook

We look forward with confidence to the second half of the year, with expected revenue growth compared to the first half in our mobile operator and Java software products and services. Management will focus on improving operational efficiencies while continue implementing our strategy in our two market segments.

In the mobile devices product line, the increasing competitiveness in the market is making fast and on-time deliveries of phones to the market, as well as cost reduction in the manufacturing of phones the priorities for our handset customers. Our strategy is to deliver complete packages of software and applications, reducing our customers' integration efforts and costs, while providing them experienced software integration, support and maintenance services.

Similarly, our objective in the home multimedia product line is to deliver well-integrated middleware software solutions required by device manufacturers through partnerships with other vendors.

Our focus for the Mobile Operator Segment will be growing our customer base for the USSD Browsing product, while expanding our product range with solutions such as portals on devices, which motivates end users to consume data, and as a result, increase data revenue for mobile operators.

We would like to take this opportunity to express our thanks to customers and shareholders for your continued support and commitment in Esmertec.

Yours sincerely,

Hans-Ulrich Müller
Vice Chairman of the
Board of Directors

Jean-Claude Martinez
Chief Executive Officer

Dübendorf, Switzerland
September, 2006

INTERIM CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2005 AND JUNE 30, 2006

(in US$ 000s)	Notes	December 31, 2005	June 30, 2006 (unaudited)
ASSETS			
Current assets			
Cash and cash equivalents		35,771	25,012
Short-term investments		19,195	251
Marketable securities		0	3,808
Trade accounts receivable	5	36,434	35,717
Other receivables		639	1,398
Inventory		3,935	3,213
Prepaid expenses and accrued income		1,257	2,633
Total current assets		97,231	72,032
Non-current assets			
Furniture and equipment		971	1,291
Intangible assets		31,295	40,000
Financial assets[1)]	6	607	1,536
Deferred tax assets		3,207	0
Total non-current assets		36,080	42,827
Total assets		**133,311**	**114,859**
LIABILITIES AND EQUITY			
Current liabilities			
Bank overdrafts		3,176	1,958
Interest-bearing loans and borrowings		121	195
Trade accounts payable		1,587	2,936
Income and withholding tax payable		2,783	2,079
Other payables		7,190	12,699
Accrued expenses		10,723	11,615
Deferred revenue		1,824	4,142
Total current liabilities		27,404	35,624
Non-current liabilities			
Interest-bearing loans and borrowings		27,935	30,398
Pension liabilities		925	1,032
Other long-term liabilities		0	4,352
Deferred revenue		366	175
Deferred tax liabilities[1)]		3,746	3,056
Total non-current liabilities		32,972	39,013
Total liabilities		**60,376**	**74,637**
Shareholders' equity			
Share capital	8	1,231	1,313
Share premium		114,737	120,213
Treasury shares		(1)	0
Cumulative translation adjustment		888	(2,213)
Accumulated losses		(44,987)	(79,156)
Total equity attributable to equity holders of the parent company		71,868	40,157
Minority interest		1,067	65
Total equity		**72,935**	**40,222**
Total liabilities and equity		**133,311**	**114,859**

[1)] Restated, see Note 2 for further information
These Interim Consolidated Financial Statements should be read in conjunction with the accompanying Notes.

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2005 AND JUNE 30, 2006

(in US$ 000s, except per share amounts)	Notes	Six months ended June 30, 2005 [1] (unaudited)	Six months ended June 30, 2006 (unaudited)
License revenue		15,009	4,037
Service revenue		5,067	5,260
Other revenue		0	328
Total revenue		**20,076**	**9,625**
Cost of license revenue		(2,061)	(283)
Cost of service revenue		(4,213)	(6,923)
Cost of other revenue		0	(296)
Total cost of revenue		**(6,274)**	**(7,502)**
Gross profit		**13,802**	**2,123**
Research and development		(2,649)	(3,867)
Sales and marketing		(3,545)	(4,724)
Bad debt expense	5	(1,885)	(903)
General and administrative		(4,375)	(5,820)
Restructuring costs	9	0	(1,707)
Amortization of intangible assets		(2,738)	(3,637)
Impairment of intangible assets	7	0	(15,635)
Loss from operations before interest and taxes		**(1,390)**	**(34,170)**
Financial income		3,018	1,827
Financial expenses		(3,364)	(4,283)
Loss before income taxes		**(1,736)**	**(36,626)**
Income tax (expense)/benefit		(236)	1,445
Net loss for the period		**(1,972)**	**(35,181)**
Attributable to:			
Equity holders of the parent company		(1,905)	(34,169)
Minority interest		(67)	(1,012)
		(1,972)	(35,181)
Basic and diluted loss per share	10	(0.18)	(2.10)

[1] Restated, see Note 2 for further information

These Interim Consolidated Financial Statements should be read in conjunction with the accompanying Notes.

INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY FOR THE SIX MONTHS ENDED JUNE 30, 2005 AND JUNE 30, 2006 (UNAUDITED)

(in US$ 000s)	Share capital	Share premium	Cumulative translation adjustment	Accumulated losses	Treasury shares	Total	Minority interest	Total equity
	Attributable to equity holders of the parent company							
Balance at December 31, 2004	**949**	**54,731**	**(6,605)**	**(29,297)**	**0**	**19,778**	**3,613**	**23,391**
Net loss				(1,905)		(1,905)	(67)	(1,972)
Other comprehensive income:								
Translation adjustment	(112)	(5,780)	4,471			(1,421)	(52)	(1,473)
Total recognized income and expense for the period	**(112)**	**(5,780)**	**4,471**	**(1,905)**	**0**	**(3,326)**	**(119)**	**(3,445)**
Increase of share capital	8	1,996			(1)	2,003		2,003
Cost of share capital increase		(1)				(1)		(1)
Stock option expense		723				723		723
Incorporation of Esmertec (China) Co.						0	85	85
Balance at June 30, 2005	**845**	**51,669**	**(2,134)**	**(31,202)**	**(1)**	**19,177**	**3,579**	**22,756**
Balance at December 31, 2005	1,231	114,737	888	(44,987)	(1)	71,868	1,067	72,935
Net loss				(34,169)		(34,169)	(1,012)	(35,181)
Other comprehensive income:								
Translation adjustment	70	6,288	(3,101)			3,257	10	3,267
Total recognized income and expense for the period	**70**	**6,288**	**(3,101)**	**(34,169)**	**0**	**(30,912)**	**(1,002)**	**(31,914)**
Increase of share capital	12	302				314		314
Stock option expense		311				311		311
Reversal of allocated deferred taxes on IPO expenses directly recognized in equity		(1,464)				(1,464)		(1,464)
Share transfer ESLab Inc., Korea		39			1	40		40
Balance at June 30, 2006	**1,313**	**120,213**	**(2,213)**	**(79,156)**	**0**	**40,157**	**65**	**40,222**

These Interim Consolidated Financial Statements should be read in conjunction with the accompanying Notes.

INTERIM CONSOLIDATED CASH FLOW STATEMENTS FOR THE SIX MONTHS ENDED JUNE 30, 2005 AND JUNE 30, 2006

(in US$ 000s)	Notes	Six months ended June 30, 2005 (unaudited)	June 30, 2006 (unaudited)
Net loss for the period		(1,972)	(35,181)
Adjustments for:			
Depreciation and amortization		2,829	3,820
Impairment of intangible assets	7	0	15,635
Loss on sale of fixed assets		15	41
Foreign exchange (gain)/loss, net, on intercompany transactions		(167)	(199)
Cost of stock options		723	311
Increase of pension accruals		8	32
Increase of bad debt reserve, net	5	1,885	903
Interest expense		1,547	1,786
Interest income		(282)	(439)
Income taxes		237	(1,445)
		4,823	(14,736)
Decrease/(increase) in trade and other receivables, accrued income and prepaid expenses		(15,497)	3,873
Decrease/(increase) in inventories		(846)	1,094
(Decrease)/increase in trade and other payables		707	(3,659)
(Decrease)/increase in accrued expenses		3,932	(1,650)
(Decrease)/increase in deferred revenue		(298)	313
Income and withholding taxes paid		(277)	(404)
Net cash used in operating activities		**(7,456)**	**(15,169)**
Capital expenditure for fixed assets		(400)	(397)
Capital expenditure for intangible assets		(3,207)	(2,673)
Acquisition of businesses, net of cash acquired	4	(1,965)	(11,839)
Investment/financing of business	6	0	(844)
Decrease of short-term investments		0	19,634
Proceeds from disposal of fixed assets		2	0
Interest received		120	182
Increase in financial assets		(26)	(29)
Net cash (used in)/provided by investing activities		**(5,476)**	**4,034**
Proceeds from borrowings		2,965	0
Repayment of borrowings		(5,908)	(1,273)
Proceeds from minorities		85	0
Proceeds from issue of share capital		8	314
Interest paid		(91)	(113)
Net cash used in financing activities		**(2,941)**	**(1,072)**
Net decrease in cash and cash equivalents		**(15,873)**	**(12,207)**
Cash and cash equivalents at beginning of period		19,817	35,771
Effect of exchange rate fluctuations on cash and cash equivalents		(1,234)	1,448
Cash and cash equivalents at end of period		**2,710**	**25,012**

These Interim Consolidated Financial Statements should be read in conjunction with the accompanying Notes.

SELECTED NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

1. CORPORATE INFORMATION AND PRINCIPLES OF CONSOLIDATION

The Esmertec Group ("Esmertec" or the "Group") consists of Esmertec AG ("the Company"), incorporated on April 1, 1999, in Dübendorf, Switzerland, and its consolidated subsidiaries, which are the following controlled companies:

Company	Share capital (million)	Ownership interest June 30, 2005	Ownership interest June 30, 2006	Consolidated since
Esmertec Inc., Dana Point, USA	US$ 0.1	100%	100%	Creation: May 2000
Esmertec Engineering Services KK (formerly eValley Inc.), Tokyo, Japan	JPY 94.63	51%	-	Acquisition: March 2004 (merged into Esmertec KK in December 2005)
Esmertec KK, Tokyo, Japan	JPY 65.7	100%	82.82% after merger with Esmertec Engineering Services KK in December 2005	Creation: September 2004
OOVM A/S, Aarhus, Denmark	DKK 0.5	100%	100%	Acquisition: July 2004
Esmertec (China) Co., Ltd., Beijing, PRC	CNY 2.0	65%	65%	Creation: April 2005
Esmertec Holding AG	CHF 1.0	-	100%	Creation: February 2006
Cellicium S.A., Bagneux, France	€ 0.08	-	100%	Acquisition: February 2006
ESLab Inc., Seoul, South Korea	KRW 60.0	-	20%, with effective operational control	Acquisition: February 2006

Esmertec is publicly traded on the Swiss Stock Exchange (SWX).
The Board of Directors authorized these Interim Consolidated Financial Statements for issuance on August 22, 2006.

2. BASIS OF PREPARATION AND ACCOUNTING POLICIES

Basis of preparation

The Interim Consolidated Financial Statements for the six months ended June 30, 2006, were prepared in accordance with IAS 34, Interim Financial Reporting.

The preparation of the Interim Consolidated Financial Statements requires management to make estimates and assumptions that affect the reported amounts of revenues, expenses, assets, liabilities and disclosure of contingent liabilities. If actual circumstances in the future deviate from such estimates and assumptions, the original estimates and assumptions will be modified as appropriate in the period in which the circumstances change. During the periods under review, there were no significant changes in estimates that should be reported under this heading except for estimates and assumptions taken in determining the value in use of the intangible assets (see Note 7).

Significant changes to accounting policies

The accounting policies used in the preparation of the Interim Consolidated Financial Statements are consistent with those used in the Annual Consolidated Financial Statements for the year ended December 31, 2005, except for the changes required by the following applicable standards which are mandatory for annual periods beginning on or after January 1, 2006:

-IAS 19 "Employee Benefits"
-IAS 39 "Financial Instruments: Recognition and Measurement"
-IAS 21 (technical correction) "The Effects of Changes in Foreign Exchange Rates"
-IFRIC 4 "Determining whether an Arrangement contains a Lease"

Such revised requirements (as well as the newly issued IFRS 6 and IFRIC 6) did not have any material effect on Esmertec's Interim Consolidated Financial Statements. For IAS 19 "Employee Benefits" the Group does not apply the alternative recognition option of posting the actuarial gains and losses directly to equity.

In addition, Esmertec has changed its segment reporting to reflect the evolution of the Group following the creation of the Mobile Operator Segment and the acquisition of Cellicium S.A. in February 2006 (see Notes 4 and 11 below). As services currently are sold only to customers who buy products, separating services into a separate segment was no longer considered meaningful by management.

Reclassification of expenses and change in balance sheet presentation

In the presentation of the Interim Consolidated Financial Statements, certain amounts in the statement of operations for the six months ended June 30, 2005, and in the balance sheet as of December 31, 2005, have been reclassified to conform to current year presentation.

The compensation and related costs for the Chief Executive Officer (CEO) and certain other senior managers previously categorized as sales and marketing expense have been reclassified as general and administrative expense, reflecting their primary roles in the current organization. This reallocation resulted in a change in the allocation of facilities expenses between these two line items. Further bad debt expenses are shown separately and other income/expenses, net, are reclassified to general and administrative expenses. The impact of the reclassifications on the Statement of Operations for the six months ended June 30, 2005, was:

Statement of operations (in US$ 000s)	**1H2005 before reclassification**	**Reclassification**	**1H2005 after reclassification**
Cost of service revenue	(4,159)	(54)	(4,213)
Research and development	(2,504)	(145)	(2,649)
Sales and marketing	(6,788)	3,243	(3,545)
General and administrative	(3,209)	(1,166)	(4,375)
Bad debt expense	0	(1,885)	(1,885)
Other income/expense, net	(7)	7	0
Total effect on net loss		**0**	

During the six months ended June 30, 2006, the cost of these personnel allocated to general and administrative expenses included the cost of the settlement agreement related to the departure of the former CEO. Such settlement cost totaled US$ 519,000, including US$ 138,000 of non-cash expense related to modifications to vested but unexercised stock options.

In the presentation of the Interim Consolidated Balance Sheet, deferred tax assets and liabilities allocable directly to the different legal entities have been netted within that jurisdiction. While this change in presentation had no impact on the Statement of Operations, the change on the Balance Sheet as of December 31, 2005 was as following:

Balance sheet (in US$ 000s)	**December 31, 2005 before reclassification**	**Reclassification**	**December 31, 2005 after reclassification**
Deferred tax assets	6,417	(3,210)	3,207
Deferred tax liabilities	(6,956)	3,210	(3,746)

3. SEASONALITY OF OPERATIONS

Management believes that Esmertec is not exposed to significant seasonal or cyclical variations in its operations.

4. BUSINESS COMBINATIONS

The following business combinations occurred during the six-month periods ended June 30, 2006 and 2005:

June 30, 2006

Acquisition of Cellicium S.A.

In February 2006, Esmertec acquired 100% of the shares of Cellicium S.A., a French software and services company, for a total purchase price of € 22.2 million (US$ 27.0 million), including transaction costs. The transaction is resulting in an expected cash outflow for 2006 in the amount of € 13.7 million (US$ 16.5 million) and will be completed by additional payments in 2007 and 2008 totaling in an estimated € 9.5 million (US$ 11.7 million), based on 2006 and 2007 performance criteria. These performance-based components of the purchase price will be settled at least 70% in cash and up to 30% in Esmertec shares. The € 9.5 million payable has been discounted to present value at the date of the acquisition using an imputed market interest rate.

The acquisition had the following effect on the Group's assets and liabilities:

Effect of the acquisition on the half-year ended June 30, 2006 in US$		**Book value before takeover**	**Fair value adjustments**	**Fair value**
Cash and cash equivalents and marketable securities		5,484		5,484
Accounts receivable		2,164		2,164
Other current assets		407		407
Non-current assets		491	9,005	9,496
Accounts payable		(722)		(722)
Deferred revenues		(1,492)		(1,492)
Other liabilities (incl. deferred tax liability)		(378)	(3,005)	(3,383)
Net assets acquired June 30, 2006		**5,954**		**11,954**
Goodwill				15,047
Total purchase price				27,001
Settled by:	- cash payment 1H2006			(13,417)
	- accrued liability			(13,219)
	- paid transaction costs			(265)
	- accrued transaction costs			(100)
Total purchase price				**(27,001)**
Paid in cash in 1H2006				(13,682)
Less cash acquired				1,846
Net cash outflow 1H2006				**(11,836)**

The purchase price allocation is about to be finalized. On a provisional basis the fair value adjustment of US$ 9,005 is allocated to customer base (US$ 6,000), intellectual property (US$ 2,895) and trademark (US$ 110).

The acquisition was effected by Esmertec Holding AG, a newly-created wholly owned Swiss subsidiary of Esmertec AG. Both Cellicium S.A. and Esmertec Holding AG are fully consolidated in Esmertec Group as from February 2006. While this acquisition did not have any effect on the result for the comparative period, revenues and net results were affected during the six months ended June 30, 2006, by US$ 3.3 million and US$ 145,000, respectively.

Acquisition of controlling interest in ESLab Inc.

In February 2006, Esmertec announced the acquisition of a controlling interest in ESLab Inc., its outsourcing partner in Korea. The purchase agreement calls for Esmertec to make an initial purchase of 20% of the outstanding shares of ESLab, combined with a number of control features which allow Esmertec AG to exercise effective control over the operations of ESLab. Consequently, ESLab is consolidated with Esmertec Group as from February 2006. The purchase price for the initial shares totaled US$ 80,000, of which half was paid in cash and half in shares of Esmertec AG (2,623 Esmertec shares, issued out of treasury shares). The transaction is resulting in an estimated net cash outflow for 2006 of US$ 3,000 (including transaction costs, net of cash acquired of US$ 96,980). In early 2007, Esmertec's ownership interest will increase to 100% at a price to be determined based on 2006 financial performance criteria. The total purchase price is estimated to be a maximum of US$ 850,000. As a result of this transaction, US$ 289,000 in intangible assets was recognized in the Balance Sheet as of June 30, 2006. The purchase price allocation is about to be finalized.

While this acquisition did not have any effect on the result for the comparative period, revenues and net results were affected during the six months ended June 30, 2006, by US$ 40,000 and US$ 159,000, respectively.

June 30, 2005

CoreTek Systems Inc.

In January 2005, Esmertec entered into an agreement for the purchase of all assets of the mobile division of CoreTek Systems Inc. (CoreTek), located in China. The transferred business included the employees, IP of the CoreTek wireless software products, assignment of customer contracts and, to a minor extent, tangible assets of CoreTek's mobile division. Under the terms of the agreement, the IP assets were transferred to Esmertec AG and recognized on June 30, 2005. These IP assets are exclusively owned by Esmertec AG.

The remaining assets were transferred into a newly-formed company, Esmertec (China) Co., Ltd. (Esmertec China), of which Esmertec owns 65% of the voting rights and the remaining 35% voting rights are owned by a founding member of CoreTek.

Esmertec China was valued at US$ 10.0 million and the consideration to be paid by Esmertec for 65% ownership was US$ 6.5 million to be paid in cash in installments during 2005 and 2006. During 2005, a total of US$ 3.5 million was paid. As a result of these transactions, US$ 8.0 million in intangible assets was recognized in the Balance Sheet as of June 30, 2005.

During 1H2006, management determined that not all the expected customer contracts had been transferred from CoreTek and a claim was made under the asset purchase agreement. Consequently, an amendment to the asset purchase agreement was signed in April 2006 reducing the remaining payments due to CoreTek in 2006 from US$ 3.0 million to US$ 2.5 million, which amount was paid in June 2006. The US$ 500,000 reduction in the original purchase price has been accounted for as a decrease of the value of goodwill.

Esmertec has a right to purchase 15% of the total share capital from the minority shareholder at a price of US$ 1.5 million in 1H2007, and has the obligation to do so if certain criteria are met.

5. TRADE ACCOUNTS RECEIVABLE

On June 29, 2005, one of Esmertec's customers, Sendo Limited, UK, was placed into administration by order of the High Court in London. Consequently a bad debt expense of US$ 1.9 million was recognized, which covered the net outstanding amount as of June 30, 2005. In the second half of 2005, the provision was increased due to the identification of several additional doubtful accounts, including primarily four Asian customers and two European customers. The Company also established a provision for risk related to the Chinese market. As of December 31, 2005, no accounts had been recovered nor written off.

During the six months ended June 30, 2006, management increased the provision related to risk in China and also provided for the net amount due from one American customer. In addition, a number of accounts provided for in 2005 were determined to be uncollectible; consequently these accounts receivable have been written off and the bad debt provision reversed. As these amounts had been fully provided for in 2005, there was no impact on the 2006 results. The net amount of bad debt expense recognized in the Statement of Operations in the six months ended June 30, 2006, is US$ 903,000 and is net of the reversal of provisions for the cost of third-party licenses initially recorded in cost of sales and other related liabilities.

6. LONG TERM INVESTMENT IN JAVAGROUND USA INC.

In February 2006, Esmertec announced a 19.99% investment in Javaground USA Inc., a California-based company focusing on porting and testing games for mobile telephones. The investment was made for US$ 444,000 (incl. transaction costs of US$ 44,000). In addition, Esmertec has agreed to provide a loan of up to a total of US$ 1.6 million to help fund Javaground's working capital requirements. The loan, which is repayable in 2008 and bears interest at 4% per annum, will be funded up to a maximum of US$ 400,000 per quarter; the first US$ 400,000 was funded at the same time the investment was made and is the amount outstanding as at June 30, 2006. The total amount of US$ 892,000 (2005, US$ 0) is included in financial assets.

Esmertec has the option to take a controlling interest in early 2007 and a further option to acquire the entire company in early 2008; the options are exercisable purely at Esmertec's discretion.

7. INTANGIBLE ASSETS

In June 2006, after a review of the latest market conditions and the internal sales pipeline, management decided to prioritize the development of products around Esmertec's core technologies, resulting in a revised product roadmap with some projects discontinued. In addition, management decided to reduce Esmertec's presence in markets where Esmertec did not have a strong position. Consequently:

- The engineering center for the OSVM product in Denmark was closed and the decision made to continue to support the existing product and customers without committing any resources to further development or commercialization of the product.
- Headcount in Esmertec KK (Japan) was reduced by more than 50%, primarily in the engineering and sales departments. Development work on acquired intellectual property was stopped.
- Intellectual property acquired from CoreTek will be used in products which will be sold primarily in the Chinese domestic market and will not have a significant penetration outside of China.

These events and decisions triggered new estimations of future cash flows from Esmertec's acquired and internally developed intangible assets. Such future cash flows, discounted to present value at a rate of 14.68%, were compared to the carrying value of the related intangible assets. Where the discounted cash flows were below the carrying value, an impairment loss was recorded.

In total an impairment loss of US$ 15,635,000 (June 30, 2005: 0) was recorded which has been fully allocated to the Mobile & Multimedia Devices Segment (formerly: Embedded Device Segment). The impairment loss can further be analyzed as follows:

Acquired intangible assets

In the six months ended June 30, 2006, impairment charges of US$ 12,930,000 were recorded, relating to the estimated impairment of certain intangible assets acquired with OOVM (Denmark), Esmertec KK (Japan) and CoreTek (China). The specific impairment charges were:

OOVM intellectual property	US$ 1,895,000
OOVM goodwill	947,000
Esmertec KK intellectual property	405,000
Esmertec KK customer base	4,824,000
Esmertec KK goodwill	4,094,000
CoreTek intellectual property	765,000
Total	**US$ 12,930,000**

Capitalized development costs

As a result of the decisions outlined above, and based on current estimates of future cash flows, management considered that the value of a number of projects with capitalized costs had been impaired and a loss in the amount of US$ 2,705,000 has been recorded in 1H2006.

Development costs incurred after technical feasibility has been demonstrated are capitalized until such time as the product incorporating the technology is commercialized. The total amount of development cost capitalized during the six months ended June 30, 2006, amounted to US$ 2,420,000 compared to US$ 2,953,000 for the six months ended June 30, 2005. Capitalized development costs are amortized over a period of five years after the commercial release of the respective product.

8. SHARE CAPITAL

During the six month periods ended June 30, 2005 and 2006, no dividends were paid out. The movements in issued share capital for the six-month period ended June 30, 2006, are as follows:

	Number of shares	Share capital (US$ 000s)
Issued capital at January 1, 2006	**16,212,469**	**1,231**
Shares issued through exercise of stock options	146,955	12
Translation adjustment		70
Issued capital at June 30, 2006	**16,359,424**	**1,313**
Thereof treasury shares	**1,060**	**0**
Authorized capital at June 30, 2006	805,055	65
Conditional capital at June 30, 2006	3,992,925	320

Shares issued through exercise of stock options

During the six-month period ended June 30, 2006, stock options were exercised resulting in the issuance of 146,955 shares at a nominal value of CHF 0.10 each, with net proceeds to the Company of CHF 14,696 (US$ 12,000).

Authorized share capital

At the annual general meeting of shareholders held on May 19, 2006, the shareholders voted to increase the authorized capital by CHF 70,000 (700,000 shares of CHF 0.10 each).

Conditional share capital

The conditional share capital comprises shares which are reserved for the exercise of stock options and for the conversion of convertible bonds.

At the annual general meeting of shareholders held on May 19, 2006, the shareholders decided to increase the conditional capital by CHF 145,949.40 (1,459,494 shares of CHF 0.10 each), of which CHF 40,000 (400,000 shares of CHF 0.10 each) are reserved for stock options and CHF 105,949.40 (1,059,494 shares of CHF 0.10 each) are reserved for the convertible bonds.

Stock options

The following table details the movements in outstanding employee stock options from January 1, 2006, until June 30, 2006:

(in 000s)	For the six months ended June 30, 2006
Opening balance	**1,489**
Granted	396
Exercised	(147)
Cancelled and expired	(26)
Ending balance	**1,712**
– Thereof vested	1,048

On June 29, 2006, the Board of Directors granted a total of 400,000 stock options to employees of Esmertec Group. The options granted have an exercise price equal to the market price of the shares on the date of grant. One fourth (25%) of the options vest at the end of the first year and the remaining 75% vest straight-line on a quarterly base over the subsequent 3 years.

No stock option expense relating to the new grants was recognized in the first half 2006 due to the timing of the grant at end of June.

The amount of stock option expense related to previous grants recognized in 1H2006 was US$ 311,000 (US$ 723,000 in H1 2005) including the one time effect of expenses to be recorded for modifications of vested unexercised options in the amount of US$ 144,000. In total there were 745,266 vested options affected. The modification is relating to the extension of the exercise period.

9. RESTRUCTURING

In June 2006, management decided to reorganize and restructure the Esmertec Group. This resulted in a decision to close the engineering center in Denmark which had been focused on the non-core OOVM product line, a reduction in the sales and support effort in Japan and the elimination of certain middle management roles. All of these decisions, which resulted in the eliminations of positions, were launched during the month of June 2006. The costs related to this restructuring of the organization have been recognized in the results of operations for the first six months of 2006 and total US$ 1.7 million. These costs comprise primarily final compensation for terminated employees and to a lesser extent, consulting fees related to the process, and costs to terminate leases.

10. LOSS PER SHARE

The basic earnings per share are calculated by dividing the net loss of US$ 34,169,000 (net loss of US$ 1,905,000 in prior period) attributable to equity holders of the parent company by the US$ 16,262,549 weighted average number of shares issued and outstanding during the period (US$ 10,807,716 in prior period).

11. SEGMENT REPORTING

In February 2006, Esmertec announced the creation of a new Mobile Operator Segment, which currently reflects primarily the results of Cellicium S.A.. Esmertec's historical activity has been based primarily on the sale of the Jbed Java Virtual Machine and related products and services. This activity is now reflected in the Mobile and Multimedia Devices Segment and is comparable to the historical results for the six months ended June 30, 2005.

	Mobile & Multimedia Devices Segment		**Mobile Operator Segment**		**Total Esmertec Group**	
	Six months ended June 30		**Six months ended June 30**		**Six months ended June 30**	
(in US$ 000s)	**2005**	**2006**	**2005**	**2006**	**2005**	**2006**
Total revenue	20,076	6,309	0	3,316	20,076	9,625
Gross profit	13,802	14	0	2,109	13,802	2,123
(Loss)/profit from operations (EBIT)	(1,390)	(34,190)	0	20	(1,390)	(34,170)

12. COMMITMENTS AND CONTINGENCIES

The Group's companies grant guarantees in the normal course of business. At December 31, 2005, there were no guarantees in favor of third parties. At June 30, 2006, performance guarantees and tender bonds had been issued to customers and prospects by the Mobile Operator Segment totaling US$ 829,000. All such bank guarantees were secured by liens in an amount equal to the guaranteed amounts on marketable security accounts held at the issuing banks. Management is not aware of any other significant commitments or contingent liabilities which have not been disclosed in these Financial Statements.

13. RELATED PARTY TRANSACTIONS

In December 2005, Esmertec entered into a service agreement with a computer games publisher controlled by Esmertec's largest shareholder with a total contract value of US$ 930,000. Under the terms of the service agreement, Esmertec has created a game porting and testing center in China and will operate it through March 2007. The only client of the porting and testing center is the games publisher. The service fee charged was based on arm's length negotiations.

In March 2007, the porting and testing center may be transferred to the games publisher at its option for a fee, or Esmertec may continue to operate the center and continue to charge service fees to the games publisher. On January 2006, the first installment in amount of US$ 250,000 was paid by the customer. The remainder is being paid in quarterly installments. US$ 330,000 was recognized in revenue during the six months ended June 30, 2006. There were no other significant transactions with related parties during the six-month periods ended June 30, 2005 and 2006.

14. POST BALANCE SHEET EVENTS

Additional loan to Javaground USA Inc.

In connection with the investment in Javaground USA Inc., Esmertec has agreed to provide a loan of up to a total of US$ 1.6 million to help fund Javaground's working capital requirements. It will be funded up to a maximum of US$ 400,000 per quarter. The first US$ 400,000 was funded in February 2006. An additional installment in the amount of US$ 400,000 was funded in July 2006.

There have been no other events between June 30, 2006, and the date of authorization of these Interim Consolidated Financial Statements that would lead to an adjustment of the carrying amounts of assets and liabilities presented as of June 30, 2006, or would otherwise have to be disclosed.

COMPANY CONTACT

Investor Relations

Deborah Choate, CFO

Phone +41 44 823 89 00

Fax +41 44 823 89 99

dchoate@esmertec.com

For electronic copies of this publication and other company information, please visit our website at:

www.esmertec.com/investor_relations/

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Corporate Headquarters

Lagerstrasse 14

8600 Dübendorf

Switzerland

Further information about Esmertec and its worldwide offices is available at www.esmertec.com.