SILICON STORAGE TECHNOLOGY INC
Form 10-Q
May 14, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2003

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 0-26944

Silicon Storage Technology, Inc.

(Exact name of Registrant as Specified in its Charter)

California	77-0225590
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

1171 Sonora Court
Sunnyvale, California 94086

(Address of Principal Executive Offices including Zip Code)

(408) 735-9110

(Registrant's Telephone Number, Including Area Code)

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 reports), and (2) has been subject to such filing requirements for the past 90 days. YES [X] NO [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). YES [X] NO [ ]

Number of shares outstanding of our Common Stock, no par value, as of the latest practicable date, April 30, 2003: 94,425,973.

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Part I.

Item 1. Condensed Consolidated Financial Statements

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended March 31, 2002 (unaudited)	Three Months Ended March 31, 2003 (unaudited)
Net revenues:		
Product revenues - unrelated parties	$ 30,869	$ 18,116
Product revenues - related parties	35,426	35,805
Technology licensing	8,287	7,788
Total net revenues	74,582	61,709
Cost of revenues:		
Cost of revenues - unrelated parties	23,130	17,928
Cost of revenues - related parties	27,372	34,573
Total cost of revenues	50,502	52,501
Gross profit	24,080	9,208
Operating expenses:		
Research and development	11,872	10,755
Sales and marketing	7,504	5,953
General and administrative	3,317	3,583

Total operating expenses	22,693	20,291
Income (loss) from operations	1,387	(11,083)
Interest and other income	968	456
Interest expense	(64)	(38)
Income (loss) before provision for income taxes	2,291	(10,665)
Provision for income taxes	733	--
Net income (loss)	$ 1,558	$ (10,665)
Net income (loss) per share - basic	$ 0.02	$ (0.11)
Shares used in per share calculation - basic	92,033	94,186
Net income (loss) per share - diluted	$ 0.02	$ (0.11)
Shares used in per share calculation - diluted	97,000	94,186

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2002	March 31, 2003
	(unaudited)	(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 103,751	$ 112,859
Short-term available-for-sale investments	41,252	47,544
Trade accounts receivable-unrelated parties, net of allowance for doubtful accounts of $4,420 at December 31, 2002 and $4,389 at March 31, 2003	10,723	8,558
Trade accounts receivable-related parties	25,248	22,707
Inventories	83,040	68,614
Deferred tax asset	17,154	20,268
Other current assets	29,671	14,869
Total current assets	310,839	295,419
Equipment, furniture and fixtures, net	16,989	15,665
Long-term available-for-sale investments	5,862	7,670
Restricted cash and cash equivalents	11,976	14,563

Restricted available-for-sale investments	24,873	22,408
Equity investments	60,910	59,735
Other assets	9,157	8,736
Total assets	$ 440,606	$ 424,196
LIABILITIES		
Current liabilities:		
Notes payable, current portion	$ 352	$ 362
Trade accounts payable-unrelated parties	28,408	21,901
Trade accounts payable-related parties	6,689	6,284
Accrued expenses and other liabilities	18,783	18,304
Deferred revenue	2,650	2,447
Total current liabilities	56,882	49,298
Other liabilities	1,873	2,009
Total liabilities	58,755	51,307
Commitments (Note 6) and Contingencies (Note 7)		
SHAREHOLDERS' EQUITY		
Common stock, no par value: Authorized: 250,000 shares Issued and outstanding: 93,295 shares at December 31, 2002 and 94,272 shares at March 31, 2003	339,598	341,445
Accumulated other comprehensive income	151	7
Retained earnings	42,102	31,437
Total shareholders' equity	381,851	372,889
Total liabilities and shareholders' equity	$ 440,606	$ 424,196

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2002	2003
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net income (loss)	$ 1,558	$ (10,665)

Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,509	2,113
Provision for doubtful accounts receivable	(68)	(31)
Provision for sales returns	3,024	(175)
Provision for excess and obsolete inventories, write-down of inventories and adverse purchase commitments	238	2,436
Deferred income taxes	--	(3,114)
Loss on disposal of equipment	--	139
Gain on sale of equity investments	--	(37)
Changes in operating assets and liabilities:		
Trade accounts receivable-unrelated parties	(6,323)	2,371
Trade accounts receivable-related parties	(8,293)	2,541
Inventories	16,665	11,990
Other current and non-current assets	(915)	15,223
Trade accounts payable-unrelated parties	1,016	(6,507)
Trade accounts payable-related parties	1,124	(405)
Accrued expenses and other liabilities	171	(574)
Deferred revenue	(425)	(203)
Net cash provided by operating activities	10,281	15,102
Cash flows from investing activities:		
Acquisition of equipment, furniture and fixtures	(1,294)	(513)
Purchases of available-for-sale investments and restricted cash and cash equivalents	(27,383)	(14,250)
Sales and maturities of available-for-sale and equity investments	20,485	7,006
Net cash used in investing activities	(8,192)	(7,757)
Cash flows from financing activities:		
Debt repayments	(76)	(84)
Issuance of shares of common stock	1,955	1,847
Other	(95)	--
Net cash provided by financing activities	1,784	1,763
Net increase in cash and cash equivalents	3,873	9,108
Cash and cash equivalents at beginning of period	93,598	103,751
Cash and cash equivalents at end of period	$ 97,471	$ 112,859

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

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SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT MARCH 31, 2003 (UNAUDITED):

1. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed interim consolidated financial statements contain all adjustments, all of which are normal and recurring in nature, necessary to fairly present our financial position, results of operations and cash flows. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim periods or for the full fiscal year. These interim financial statements should be read in conjunction with the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2002.

The year-end balance sheet at December 31, 2002 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. Please refer to the audited financial statements in our Annual Report on Form 10-K for the year ended December 31, 2002.

Reclassifications

Certain amounts in our prior years consolidated financial statements have been reclassified to conform to the current year presentation. These reclassifications have no impact on our previously reported net income (loss).

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 143, "Accounting for Asset Retirement Obligations," which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. We adopted SFAS No. 143 during the quarter ended March 31, 2003. The adoption of SFAS No. 143 did not have a significant impact on our consolidated financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Exit or Disposal Activities." SFAS No. 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for under Emerging Issues Task Force, or EITF, No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The scope of SFAS No. 146 also includes costs related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. SFAS No. 146 was effective for exit or disposal activities initiated after December 31, 2002. We adopted SFAS No. 146 during the quarter ended March 31, 2003. The adoption of SFAS No. 146 did not have a significant impact on our consolidated financial statements. The effect of adoption of SFAS No. 146 will change on a prospective basis the timing of when restructuring charges are recorded from a commitment date approach to when the liability is incurred.

In November 2002, the FASB issued FASB Interpretation, or FIN, No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 requires that a liability be recorded in the guarantor's balance sheet upon issuance of a guarantee. In addition, FIN No. 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity's product warranty liabilities. The initial recognition and initial measurement provisions of FIN No. 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements of FIN No. 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We adopted the disclosure provision of FIN No. 45 for the year ended December 31, 2002 and since December 31, 2002 the recognition and measurement provisions of FIN No. 45 has not had a material impact on our consolidated financial statements.

In November 2002, the EITF reached a consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21

will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently assessing the impact of EITF Issue No. 00-21 on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. We have chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the estimate of the market value of our stock at the date of the grant over the amount an employee must pay to acquire our stock. We have adopted the interim disclosure provisions for our financial reports for the quarter ended March 31, 2003. As the adoption of this standard involves disclosures only, we do not expect a material impact on our consolidated financial statements.

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN No. 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN No. 46 must be applied for the first interim or annual period beginning after June 15, 2003. We are currently reviewing our equity investments and associated relationships to determine if they are variable interest entities as defined by FIN No. 46. It is reasonably possible that we are the primary beneficiary of or hold a significant variable interest in a variable interest entity. The nature, purpose and activities of the potential variable interest entities is outlined in Note 13 of our Notes to the Consolidated Financial Statements filed in our Annual Report on Form 10-K for the year ended December 31, 2002. Our maximum exposure to loss as a result of our involvement with the potential variable interest entities is our investment in such entities as we are not obligated to provide any additional financing.

2. Computation of Net Income (Loss) Per Share

We have computed and presented net income (loss) per share under two methods, basic and diluted. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the sum of the weighted average number of common shares outstanding and potential common shares (when dilutive). A reconciliation of the numerator and the denominator of basic and diluted net income (loss) per share is as follows (in thousands, except per share amounts):

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	Three Months Ended March 31, 2002	Three Months Ended March 31, 2003
Numerator - basic		
Net income (loss)	$ 1,558	$ (10,665)
Denominator - basic		
Weighted average common stock outstanding	92,033	94,186
Basic net income (loss) per share	$ 0.02	$ (0.11)
Numerator - diluted		
Net income (loss)	$ 1,558	$ (10,665)
Denominator - diluted		
Weighted average common stock outstanding	92,033	94,186
Dilutive potential of common stock equivalents:		
Options	4,967	--
	97,000	94,186
Diluted net income (loss) per share	$ 0.02	$ (0.11)

Anti-dilutive stock options to purchase 3,447,000 shares of common stock with weighted average exercise price of $16.72 were excluded from the computation of diluted net income per share for the three months ended March 31, 2002 because the exercise price of these options exceeded the average fair market value of our common stock for the three months ended March 31, 2002. Stock options to purchase 10,215,000 shares of common stock were outstanding as of March 31, 2003 with weighted average exercise price of $7.59. These stock options were not included in the computation of diluted net loss per share for the three months ended March 31, 2003 because we had a net loss for this period.

Stock Compensation:

No compensation cost has been recognized for our 1995 Equity Incentive Plan, our 1995 Non-Employee Directors' Stock Option Plan or our 1995 Employee Purchase Plan. Had compensation cost for these plans been determined based on the fair value at the grant date for the awards, our net income (loss) and net income (loss) per share for the three months ended March 31, 2002 and 2003 would have been decreased to the pro forma amounts indicated below (in thousands):

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2003
Net income (loss), as reported	$ 1,558	$ (10,665)
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(3,062)	(1,821)
Pro forma net loss	$ (1,504)	$ (12,486)
Pro forma net loss per share - basic and diluted	$ (0.02)	$ (0.13)

3. Restricted Cash and Cash Equivalents and Restricted Available-for-Sale Investments

In July 2002, in connection with our Atmel litigation (see Note 7 of these Notes to the Condensed Consolidated Financial Statements), we posted a bond in the amount of $36.5 million pending our appeal. In connection with the bond, we have pledged cash, cash equivalents and available-for-sale investments in the amount of $36.5 million under the custody of one financial institution, and classified these amounts as restricted cash and cash equivalents and restricted available-for-sale investments. As of March 31, 2003, total restricted cash and cash equivalents and restricted available-for-sale investments was $37.0 million, which consisted of the bond in the amount of $36.5 million and cumulative interest earned in the amount of $471,000.

4. Available-for-Sale Investments

We consider cash and all highly liquid investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. Substantially all of our cash and cash equivalents are in the custody of three major financial institutions.

Our investments comprise federal, state, and municipal government obligations and foreign and public corporate debt securities. Investments with maturities of less than one year at the balance sheet date are considered short-term and investments with maturities greater than one year at the balance sheet date are considered long-term. All these investments are classified as available-for-sale and carried at fair value, based on quoted market prices, with the unrealized gains or losses, net of tax, reported in shareholders' equity as other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Realized gains and losses are recorded on the specific identification method. Realized gains and realized losses for the three months ended March 31, 2003 were not material.

King Yuan Electronics Company Limited, or KYE, and Insyde Software Corporation, or Insyde, are Taiwanese companies that completed initial public offerings on the Taiwan Stock Exchange during 2001 and 2003, respectively. Investments in these companies have been included in "Long-term available-for-sale investments," and we have recorded the investment at fair market value, with unrealized gains and losses, net of tax, reported in shareholders' equity as accumulated other comprehensive income. If a loss is other than temporary, it is reported as an "Impairment of equity investments." Dividends and other distributions of earnings from the investees, if any, are included in other income when declared.

The fair value of available-for-sale investments, including restricted available-for-sale investments, as of March 31, 2003 were as follows (in thousands):

	Amortized Cost	Unrealized Gain (Loss)	Fair Value
Corporate bonds and notes..................	$ 290	$ --	$ 290
Government bonds and notes.................	154,375	83	154,458
Foreign listed equity securities...........	2,264	(72)	2,192
Total bonds, notes and equity securities....	$ 156,929	$ 11	156,940
Less amounts classified as cash equivalents..........................			(79,318)
Total short and long-term available-for-sale investments........			$ 77,622
Contractual maturity dates for investments in bonds and notes:			
Less than 1 year..			$ 47,544
Less than 1 year - restricted................................			21,866
1 to 5 year..			5,478
1 to 5 year - restricted.....................................			542
			$ 75,430

The unrealized gains as of March 31, 2003 are recorded in accumulated other comprehensive income, net of tax of $4,000.

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The fair value of available-for-sale investments as of December 31, 2002 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Fair Value
Corporate bonds and notes..................	$ 359	$ --	$ 359
Government bonds and notes.................	123,763	107	123,870

Foreign listed equity securities	1,299	138	1,437
Total bonds, notes and equity securities	$ 125,421	$ 245	125,666
Less amounts classified as cash equivalents			(53,679)
Total short and long-term available-for-sale investments			$ 71,987
Contractual maturity dates for investments in bonds and notes:			
Less than 1 year			$ 41,252
Less than 1 year - restricted			24,873
1 to 5 year			4,425
			$ 70,550

The unrealized gains as of December 31, 2002 are recorded in accumulated other comprehensive income, net of tax of $94,000.

5. Selected Balance Sheet Detail

Details of selected balance sheet accounts are as follows (in thousands):

Inventories comprise:

	December 31, 2002	March 31, 2003
Raw materials	$ 40,036	$ 31,825
Work in process	8,923	5,152
Finished goods	28,608	25,668
Inventories held at logistics center	5,473	5,969
	$ 83,040	$ 68,614

Inventories are stated at the lower of cost, determined on a first-in, first-out basis, or market value. We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and have a significant impact on our financial position and results of operations. Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. Some of our customers have requested that we ship them product that has a finished goods date of manufacture that is less than one year old. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on hand finished goods inventory with a date of manufacture of greater than one year old, which could result in a significant adjustment and could harm our financial results. As of March 31, 2003, our allowance for excess and obsolete inventories includes an allowance for our on hand finished goods inventory with a date of manufacture of greater than two years old and for certain products with a date of manufacture of greater than one year old. While we have programs to minimize the required inventories on hand and we consider technological obsolescence when estimating allowances for potentially excess and obsolete inventories and those required to reduce recorded amounts to market values, it is reasonably possible that such estimates could change in the near term. Such changes in estimate could have a significant impact on our financial position and results of operations.

Accrued expenses and other liabilities comprise:

	December 31, 2002	March 31, 2003
Accrued compensation and related items	$ 5,070	$ 4,067
Accrued income tax payable	6,782	8,050
Accrued liabilities-related parties	473	485
Accrued warranty	492	489
Other accrued liabilities	5,966	5,213
	$ 18,783	$ 18,304

Accrued warranty:

Balance at December 31, 2002	$ 492
Accruals for warranties issued during the period	207
Settlements made during the period	(210)
Balance at March 31, 2003	$ 489

Our products are generally subject to warranty and we provide for the estimated future costs of repair, replacement or customer accommodation upon shipment of the product in the accompanying statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenues and assumes that we have to replace products subject to a claim. For new products, we use our historical percentage for the appropriate class of product.

Our technology license agreements generally include an indemnification clause that indemnifies the licensee against liability, damages and legal defense costs arising from any claims of patent, copyright, trademark or trade secret infringement by our proprietary technology. The terms of these guarantees approximate the terms of the technology license agreements, which typically range from five to ten years. Our current license agreements expire from 2003 through 2014. The maximum possible amount of future payments we could be required to make, if such indemnifications were required on all of these agreements, is $34.5 million. We have not recorded any liabilities as of March 31, 2003 related to these indemnities.

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These indemnities include indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to our directors and officers to the maximum extent permitted under the laws of California. In addition, we have contractual commitments to some customers, which could require us to incur costs to repair an epidemic defect with respect to our products outside the normal warranty period if such defect were to occur. The duration of these indemnities, commitments and guarantees varies. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential future payments that we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

6. Commitments

As of March 31, 2003, we had outstanding purchase commitments with our foundry vendors of $25.9 million for delivery in 2003. We have recorded a liability of $1.4 million for adverse purchase commitments.

During the third quarter of 2001, we recorded a period charge to other operating expense of $756,000 relating to an operating lease for an abandoned building. This charge represented the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge was an estimate and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. We may be unable to secure subtenants for such space due to the recent decrease in demand for commercial rental space in Silicon Valley. If we are not successful in subleasing our unused office space, we may be required to take an additional period charge for the balance of the future lease cost. At December 31, 2002 and March 31, 2003, payments made have reduced the recorded liability to $473,000 and $425,000, respectively.

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7. Contingencies

On January 3, 1996, Atmel Corporation sued us in the U.S. District Court for the Northern District of California. Atmel's complaint alleged that we willfully infringe five U.S. patents owned by or exclusively licensed to Atmel. Atmel later amended its complaint to allege infringement of a sixth patent. Regarding each of these six patents, Atmel sought a judgment that we infringe the patent, an injunction prohibiting future infringement, and treble damages, as well as attorney's fees and expenses.

On two of the six patents, the District Court ruled by summary judgment that we did not infringe. Two of the other patents were invalidated by another U.S. District Court in a proceeding to which we were not a party, but this decision was later reversed by the Federal Circuit Court of Appeals. As discussed below, as the result of a ruling in another case, Atmel has withdrawn its allegations as to another patent ("the '747 patent"). At this point, three patents remain at issue in Atmel's District Court case against us ("the '811, '829 and '903 patents"). All of these patents have expired, so Atmel cannot obtain an injunction against the sale of our products.

On February 17, 1997, Atmel filed an action with the International Trade Commission, or ITC, against two suppliers of our parts, involving four of the six patents that Atmel alleged that we infringe in the District Court case above. We intervened as a party to that investigation.

On October 16, 2000, the ITC found the '903 patent valid and infringed, and ruled that we could not import into the United States certain products that use the claimed circuit made by one of our suppliers. The ITC also ruled that we do not infringe the '811 and '829 patents. We appealed from the Limited Exclusion Order, and in August, 2001 the Court of Appeals for the Federal Circuit issued an opinion giving its reasons for denying that appeal. The '903 patent and the ITC's Limited Exclusion Order expired on September 14, 2001.

On January 14, 2002, the court in *Atmel Corp. v. Macronix America, Inc.* denied Atmel's motion to correct the '747 patent. As a result of the Court's decision, Atmel withdrew its claims against us based on the '747 patent.

A jury trial on the '811 and '829 patents began on April 8, 2002. The jury found that we willfully infringed those patents, and awarded Atmel $20.0 million in actual damages. On May 7, 2002, the Court entered judgment in the total amount of $36.5 million, which includes the original $20.0 million. The '811 and '829 patents expired in February 2002. Therefore, we are not precluded from selling any of our products. We believe that there were significant errors in both the infringement and the damages verdicts, and filed a Notice of Appeal on July 16, 2002. On October 7, 2002, we filed our opening brief in that appeal. Our final reply brief was filed on January 16, 2003. Atmel filed its final brief on January 30, 2003. On May 8, 2003, the Court of Appeals for the Federal Circuit heard oral arguments on our appeal of the judgment finding that we infringed the '811 and '829 patents. We anticipate that the Court will rule in two to three months. Atmel has agreed to stay its enforcement of this judgment pending our appeal. In July 2002, we posted a bond in the amount of $36.5 million pending the appeal. In connection with the bond, we have pledged cash, cash equivalents and available-for-sale investments in the amount of $36.5 million. As of March 31, 2003, this amount is included in restricted cash, cash equivalents and available-for-sale investments in our balance sheet (see Note 3 of these Notes to the Condensed Consolidated Financial Statements).

Trial on the '903 patent was severed and heard before a jury beginning on July 29, 2002. The Court ruled that we infringed that patent, so the jury was asked to decide whether the patent is valid and, if so, assess what, if any, damages are due Atmel. The jury was unable to unanimously decide whether the '903 patent is valid, and a mistrial was declared. The Court denied Atmel's request to schedule a retrial until the appeals of the verdict regarding the '811 and '829 patents are decided.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have incurred certain costs while defending these matters. There can be no assurance the Atmel complaint or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of March 31, 2003.

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8. Segment Reporting

Our operations involve the design, development, manufacturing, marketing and technical support of our nonvolatile memory products. We offer low and medium density devices that target a broad range of existing and emerging applications in the digital consumer, networking, wireless communications and Internet computing markets. Our products are differentiated based upon attributes such as density, voltage, access speed, package and predicted endurance. We also license our technology for use in non-competing applications.

We manage our business in four reportable segments: the Standard Memory Product Group, or SMPG, the Application Specific Product Group, or ASPG, the Special Product Group, or SPG, and Technology Licensing. We do not allocate operating expenses, interest and other income, interest expense, impairment of equity investments or provision for or benefit from income taxes to any of these segments for internal reporting purposes, as we do not believe that allocating these expenses are material in evaluating a business unit's performance.

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family. These product families allow us to produce products optimized for cost and functionality to support a broad range of mainstream applications that use nonvolatile memory products. Effective January 1, 2003, we transferred certain MTP products from SMPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002.

ASPG includes Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and Low Pin Count, or LPC, flash products. ASPG also includes flash embedded controllers such as the ATA controller. Effective January 1, 2003, we transferred certain flash microcontroller products from ASPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002.

SPG includes ComboMemory, ROM/RAM Combos, MTP, flash microcontroller and other special flash products. Effective January 1, 2003, we transferred certain MTP products from SMPG to SPG and certain flash microcontroller products from ASPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002.

Technology Licensing includes both license fees and royalties.

The following table shows our product revenues and gross profit (loss) for each segment (in thousands):

	Three Months Ended March 31, 2002		Three Months Ended March 31, 2003	
	Revenues	Gross Profit	Revenues	Gross Profit (Loss)
SMPG	$ 42,150	$ 8,286	$ 36,046	$ (1,711)
ASPG	20,390	5,531	13,775	2,901
SPG	3,755	1,976	4,100	230
Technology Licensing	8,287	8,287	7,788	7,788
	$ 74,582	$ 24,080	$ 61,709	$ 9,208

9. Comprehensive Income (Loss)

The components of comprehensive income (loss), net of tax, are as follows (in thousands):

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2003
Net income (loss)	$ 1,558	$ (10,665)
Other comprehensive income:		
Change in net unrealized gains on investments, net of tax	821	(144)
Total comprehensive income (loss)	$ 2,379	$ (10,809)

The components of accumulated other comprehensive income are as follows (in thousands):

	December 31, 2002	March 31, 2003
Net unrealized gains on investments, net of tax	$ 151	$ 7

10. Related Party Transactions and Balances

The following table is a summary of our related party revenues and purchases for the three months ended March 31, 2002 and 2003, and our related party accounts receivable and accounts payable and accruals as of December 31, 2002 and March 31, 2003 (in thousands):

	Three Months Ended March 31, 2002		Three Months Ended March 31, 2003	
	Revenues	Purchases	Revenues	Purchases
Silicon Technology Co., Ltd.	$ 473	$ --	$ 387	$ --
Ambit Microsystems Corp.	129	--	--	--
Apacer Technology, Inc.	194	50	386	133
Professional Computer Technology Limited	141	--	--	--
Silicon Professional Technology Ltd.	34,489	--	35,032	--
King Yuan Electronics Company, Limited	--	3,608	--	3,896
Powertech Technology, Incorporated	--	2,600	--	2,260
	$ 35,426	$ 6,258	$ 35,805	$ 6,289

	December 31, 2002		March 31, 2003	
	Trade Accounts Receivable	Trade Accounts Payable and Accruals	Trade Accounts Receivable	Trade Accounts Payable and Accruals
Silicon Technology Co., Ltd.	$ 459	$ --	$ 99	$ --
Apacer Technology, Inc.	141	119	210	134
Professional Computer Technology Limited	--	73	--	107
Silicon Professional Technology Ltd.	24,648	432	22,397	444
King Yuan Electronics Company, Limited	--	4,285	--	3,798
Powertech Technology, Incorporated	--	2,253	--	2,286
	$ 25,248	$ 7,162	$ 22,706	$ 6,769

Professional Computer Technology Limited, or PCT, continues to earn commissions for direct sales transactions to its customers. PCT's commissions are paid at the same rate as all of our other stocking representatives in Asia. In addition,

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we continue to pay Silicon Professional Technology Ltd., or SPT, a fee for providing logistics center functions. This fee is based on a percentage of revenue for each product shipped through SPT to our end customers. The fee paid to SPT covers the costs of warehousing and insuring inventory and accounts receivable, personnel costs required to maintain logistics and information technology functions and the costs to perform billing and collection of accounts receivable.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion may be understood more fully by reference to the consolidated financial statements, notes to the consolidated financial statements, and management's discussion and analysis of financial condition and results of operations contained in our Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the Securities and Exchange Commission.

The following discussion contains forward-looking statements, which involve risk and uncertainties. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors which are difficult to forecast and can materially affect our quarterly or annual operating results. Fluctuations in revenues and operating results may cause volatility in our stock price. Please refer to the section below entitled "Business Risks."

Overview

We are a leading supplier of flash memory semiconductor devices for the digital consumer, networking, wireless communication and Internet computing markets.

The semiconductor industry has historically been cyclical, characterized by periodic changes in business conditions caused by product supply and demand imbalance. When the industry experiences downturns, they often occur in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. These downturns are characterized by weak product demand, excessive inventory and accelerated declines of selling prices. In some cases, downturns, such as the one we have experienced since late 2000, have lasted for more than a year. Due to the continued weak demand environment and economic uncertainty exacerbated by the outbreak of severe acute respiratory syndrome, or SARS, we believe that the industry's full recovery may be further pushed out. We expect the slow recovery from the current industry downturn will impact our selling prices during the second quarter. However, we expect that the pricing environment will improve in the second half of 2003.

Our product sales are made primarily using short-term cancelable purchase orders. The quantities actually purchased by the customer, as well as shipment schedules, are frequently revised to reflect changes in the customer's needs and in our supply of product. Accordingly, our backlog of open purchase orders at any given time is not a meaningful indicator of future sales. Changes in the amount of our backlog do not necessarily reflect a corresponding change in the level of actual or potential sales.

We derived 80.7%, 88.5% and 89.6% of our net product revenues during 2001, 2002 and the three months ended March 31, 2003, respectively, from product shipments to Asia. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia.

Our top ten end customers, which excludes transactions through stocking representatives and distributors, accounted for 31.5%, 36.8% and 39.9% of our net product revenues in 2001, 2002 and the three months ended March 31, 2003, respectively.

No single end customer, which we define as original equipment manufacturers, or OEMs, original design manufacturers, or ODMs, contract electronic manufacturers, or CEMs, or end users, represented 10.0% or more of our net product revenues during 2001, 2002 or the three months ended March 31, 2003.

Since March 2001, we have been increasing our out-sourcing activities with our customer service logistics to support our customers. Currently, Silicon Professional Technology Ltd., or SPT, supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly owned subsidiary of one of our stocking representatives in Taiwan, Professional Computer Technology Limited, or PCT. Please see a description of our relationship with PCT under "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2002. Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. For the year ended December 31, 2002 and the three months ended March 31, 2003, SPT serviced end customer sales accounted for 57.4% and 65.0% of our net product revenues recognized. As of December 31, 2002 and March 31, 2003, SPT, our logistics center, represented 68.5% and 71.6% of our accounts receivable, respectively.

We ship products to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, distributors, and our logistics center. Our stocking representatives, distributors and logistics center reship our products to our end customers, including OEMs, ODMs, CEMs and end users. No stocking representative or distributor serviced more than 10.0% of our end customer sales in 2001, 2002 or the three months ended March 31, 2003.

Critical Accounting Estimates

For information related to our revenue recognition and other critical accounting estimates, please refer to the "Critical Accounting Estimates" section of "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in our Annual Report on Form 10-K for the year ended December 31, 2002.

Results of Operations: Quarter Ended March 31, 2003

Net Revenues

Net revenues were $61.7 million for the first quarter of 2003 as compared to $62.8 million in the fourth quarter of 2002 and $74.6 million for the first quarter of 2002. Net revenues decreased compared to the fourth quarter of 2002 due to decreased average selling prices for our products, offset by increased unit shipments. Net revenues for the first quarter of 2003 decreased compared to the first quarter of 2002 also due to decreased average selling prices, offset by increased unit shipments of our products. Average selling prices fluctuate due to a number of factors including the overall supply and demand for our products in the marketplace, maturing product cycles and general economic conditions.

Product Revenues

. Product revenues were $53.9 million in the first quarter of 2003 as compared to $56.8 million in the fourth quarter of 2002 and $66.3 million for the first quarter of 2002. Product revenues decreased compared to the fourth quarter of 2002 due to decreased average selling prices for our products by 12.0%, offset by increased unit shipments of our products by 6.4%. Product revenues decreased compared to the first quarter of 2002 due to decreased average selling prices for our products by 18.9%, offset by increased unit shipments of our products by 1.3%. Unit shipments fluctuate due to overall industry supply and demand.

Technology Licensing Revenues. Revenues from license fees and royalties were $7.8 million in the first quarter of 2003, as compared to $6.0 million in the fourth quarter of 2002 and $8.3 million in the first quarter of 2002. We anticipate that revenues from technology licensing may fluctuate significantly in the future.

Gross Profit

Gross profit was $9.2 million, or 14.9% of net revenues, in the first quarter of 2003 as compared to gross profit of $6.7 million, or 10.7% of net revenues, in the fourth quarter of 2002 and $24.1 million, or 32.3% of net revenues, in the first quarter of 2002. The increase in gross profit from the fourth quarter of 2002 to the first quarter of 2003 is primarily due to increased unit shipments of our products by 6.4% and increased license revenues by $1.7 million, offset by decreases in average selling prices by 12.0%. The decrease in gross profit in the first quarter of 2003 when compared to the first quarter of 2002 is due primarily to decreases in average selling prices. Product gross margin was 2.6% for the first quarter of 2003, compared to 1.2% for the fourth quarter of 2002 and 23.8% for the first quarter of 2002. The increase in product gross margin from the fourth quarter of 2002 to the first quarter of 2003 relates to improved costs and lower inventory charges relative to the fourth quarter of 2002. The decrease in product gross margin from the first quarter of 2002 to the first quarter of 2003 relates to decreased average selling prices of our products by 18.9% and $2.4 million of inventory valuation adjustments recorded in the first quarter of 2003. For other factors affecting our gross profit, please also see "Business Risks - We incurred significant inventory valuation adjustments in 2001 and 2002 and we may incur additional significant inventory valuation adjustments in the future."

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, and general and administrative expenses. Operating expenses were $20.3 million, or 32.9% of net revenues, in the first quarter of 2003, compared to $20.6 million, or 32.7% of net revenues, in the fourth quarter of 2002, and $22.7 million, or 30.4% of net revenues, in the first quarter of 2002. The decrease from the fourth quarter of 2002 by 1.3% was primarily due to a decrease of $545,000 in masks and evaluation parts expenses, offset by an overall increase of $332,000 in our headcount and related costs. Operating expenses decreased by 10.6% from the first quarter of 2002. The decrease related primarily to decreases of $1.1

million in masks and evaluation parts expenses, $661,000 in commissions due to decreased product revenues, $392,000 in legal expenses and $302,000 in depreciation and amortization expenses. We anticipate that we will continue to devote substantial resources to research and development, sales and marketing and to general and administrative, and that these expenses may increase in dollars.

Research and development

. Research and development expenses include costs associated with the development of new products, enhancements to existing products, quality assurance activities and occupancy costs. These costs consist primarily of employee salaries and benefits and the cost of materials such as wafers and masks. Research and development expenses were $10.8 million, or 17.4% of net revenues, during the first quarter of 2003, as compared to $11.3 million, or 18.0% of net revenues, during the fourth quarter of 2002 and $11.9 million, or 15.9% of net revenues, during the first quarter of 2002. Research and development expenses decreased by 5.0% from the fourth quarter of 2002 and by 9.4% from the first quarter of 2002 due primarily to a decrease of $545,000 and $1.1 million, respectively, in masks and evaluation parts expenses in the first quarter of 2003, as compared to the prior quarter and the same quarter of last year, respectively. We expect that research and development expenses may increase in dollars.

Sales and marketing

. Sales and marketing expenses consist of commissions, headcount and related costs, as well as travel, entertainment and promotional expenses. Sales and marketing expenses were $6.0 million, or 9.6% of net revenues, in the first quarter of 2003, as compared to $6.4 million, or 10.2% of net revenues, in the fourth quarter of 2002 and $7.5 million, or 10.1% of net revenues, during the first quarter of 2002. The decrease in sales and marketing expenses by 6.9% from the fourth quarter of 2002 to the first quarter of 2003 was primarily attributable to decreased headcount and related costs by $420,000. The decrease in sales and marketing expenses by 20.7% from the first quarter of 2002 to the first quarter of 2003 was primarily attributable to decreased headcount and related costs by $408,000 and decreased commissions expenses by $661,000. We expect sales and marketing expenses may increase in dollars. In addition, fluctuations in revenues will cause fluctuations in sales and marketing expenses as it impacts our commission expenses.

General and administrative.

General and administrative expenses consist of salaries and related costs for administrative, executive and finance personnel, recruiting costs, professional services and legal fees and allowances for doubtful accounts. General and administrative expenses were $3.6 million, or 5.8% of net revenues, in the first quarter of 2003, as compared to $2.8 million, or 4.5% of net revenues, in the fourth quarter of 2002 and $3.3 million, or 4.4% of net revenues, during the first quarter of 2002. Expenses increased by 26.1% from the fourth quarter of 2002 primarily due to increased headcount and related costs by $815,000. The increase in general and administrative expenses by 8.0% from the first quarter of 2002 was primarily due to increased headcount and related costs by $869,000, offset by decreases in depreciation and amortization expenses by $302,000 and legal expenses related to the Atmel litigation by $392,000. We anticipate that general and administrative expenses may increase in dollars as we scale our facilities, infrastructure, and headcount to support our overall expected growth. We may also incur additional expenses in connection with the Atmel litigation. For further information on this litigation see "Legal Proceedings."

Interest and other income.

Interest and other income was $456,000, or 0.7% of net revenues, during the first quarter of 2003, as compared to $652,000, or 1.0% of net revenues, during the fourth quarter of 2002 and $968,000, or 1.3% of net revenues, during the first quarter of 2002. Interest income decreased both from the fourth and first quarters of 2002 to the first quarter of 2003 due to decreasing interest rates on invested cash.

Interest expense.

Interest expense was $38,000 for the first quarter of 2003 as compared to $43,000 for the fourth quarter of 2002 and $64,000 for the first quarter of 2002. Interest expense relates to interest and fees under our line of credit and to our notes payable. We terminated our line of credit in July 2002.

Provision for Income Taxes

We had a tax rate of zero in the first quarter of 2003. This compares with a tax benefit of $5.5 million in the fourth quarter of 2002 which was based on a 42.0% tax rate on loss before taxes and a tax provision of $733,000 in the first quarter of 2002 which was based on a 32.0% tax rate on income before taxes. We plan to implement our international tax structure during the second half of 2003. We expect our tax rate to be 0% for the remainder of 2003. Our tax rate may change depending on our profitability and the timing of the implementation of certain tax planning strategies. As of March 31, 2003, we have total short-term and long-term deferred tax assets of $25.4 million. If we continue to incur net losses in the future and the realization of the deferred tax assets through future taxable income becomes uncertain, we may be required to provide a valuation allowance for our deferred tax assets.

Segment Reporting

We manage our business in four reportable segments: SMPG, ASPG, SPG and Technology Licensing. Refer to Note 8 of the Notes to the Condensed Consolidated Financial Statements for revenue and gross profit information by reportable segment.

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family. Effective January 1, 2003, we transferred certain MTP products from SMPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. SMPG revenues were $36.0 million for the first quarter of 2003, as compared to $37.1 million in the fourth quarter of 2002 and $42.1 million in the first quarter of 2002. The decrease in revenues, both from the fourth and first quarters of 2002, was primarily due to lower average selling prices by 9.7% and 15.7%, respectively, offset by increased unit shipments by 7.6% and 3.3%, respectively. Gross margin increased from negative 10.8% in the fourth quarter of 2002 to negative 4.7% in the first quarter of 2003 primarily due to changes in product mix. Gross margin decreased from 19.7% in the first quarter of 2002 to negative 4.7% in the first quarter of 2003 primarily due to lower average selling prices.

ASPG includes Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and Low Pin Count, or LPC, flash products. ASPG also includes flash embedded controllers such as the ATA controller. Effective January 1, 2003, we transferred certain flash microcontroller products from ASPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. ASPG revenues were $13.8 million for the first quarter of 2003, as compared to $15.8 million in the fourth quarter of 2002 and $20.4 million in the first quarter of 2002. The decrease in revenues from the fourth quarter of 2002 was primarily due to lower average selling prices by 15.1%. The decrease in revenues from the first quarter of 2002 was primarily due to lower average selling prices by 26.4% and lower unit shipments by 7.4%. Gross margin decreased from 29.3% in the fourth quarter of 2002 to 21.1% in the first quarter of 2003 primarily due to decreased average selling prices. Gross margin decreased from 27.1% in the first quarter of 2002 to 21.1% in the first quarter of 2003 primarily due to lower average selling prices and decreased unit shipments.

SPG includes ComboMemory, ROM/RAM Combos, MTP, flash microcontroller and other special flash products. Effective January 1, 2003, we transferred certain MTP products from SMPG to SPG. Accordingly, our first quarter of 2002 segment revenues and gross profit (loss) information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. SPG revenues were $4.1 million for the first quarter of 2003, as compared to $3.9 million in the fourth quarter of 2002 and $3.8 million in the first quarter of 2002. The increase in revenues from the fourth quarter of 2002 was primarily due to increased unit shipments by 7.0%, offset by lower average selling prices by 7.8%. The increase in revenues from the first quarter of 2002 was primarily due to increased unit shipments by 5.3% and higher average selling prices by 3.2%. Gross margin increased from 2.1% in the fourth quarter of 2002 to 5.6% in the first quarter of 2003 primarily due to changes in product mix. Gross margin decreased from 52.6% in the first quarter of 2002 to 5.6% in the first quarter of 2003 primarily due to changes in product mix.

Revenue and gross profit related to Technology Licensing was $7.8 million for the first quarter of 2003, $6.0 million for the fourth quarter of 2002 and $8.3 million for the first quarter of 2002.

Related Party Transactions and Balances

The following table is a summary of our related party revenues and purchases for the quarters ended March 31, 2002 and 2003, and our related party accounts receivable and accounts payable and accruals as of December 31, 2002 and

March 31, 2003 (in thousands). For a description of our relationship with these parties please see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2002.

	Three Months Ended March 31, 2002		Three Months Ended March 31, 2003	
	Revenues	Purchases	Revenues	Purchases
Silicon Technology Co., Ltd.	$ 473	$ --	$ 387	$ --
Ambit Microsystems Corp.	129	--	--	--
Apacer Technology, Inc.	194	50	386	133
Professional Computer Technology Limited	141	--	--	--
Silicon Professional Technology Ltd.	34,489	--	35,032	--
King Yuan Electronics Company, Limited	--	3,608	--	3,896
Powertech Technology, Incorporated	--	2,600	--	2,260
	$ 35,426	$ 6,258	$ 35,805	$ 6,289

	December 31, 2002		March 31, 2003	
	Trade Accounts Receivable	Trade Accounts Payable and Accruals	Trade Accounts Receivable	Trade Accounts Payable and Accruals
Silicon Technology Co., Ltd.	$ 459	$ --	$ 99	$ --
Apacer Technology, Inc.	141	119	210	134
Professional Computer Technology Limited	--	73	--	107
Silicon Professional Technology Ltd.	24,648	432	22,397	444
King Yuan Electronics Company, Limited	--	4,285	--	3,798
Powertech Technology, Incorporated	--	2,253	--	2,286
	$ 25,248	$ 7,162	$ 22,706	$ 6,769

PCT continues to earn commissions for direct sales transactions to its customers. PCT's commissions are paid at the same rate as all of our other stocking representatives in Asia. In addition, we continue to pay SPT a fee for providing logistics center functions. This fee is based on a percentage of revenue for each product shipped through SPT to our end customers. The fee paid to SPT covers the costs of warehousing and insuring inventory, personnel costs required to maintain logistics and information technology functions and the costs to perform billing and collection of accounts receivable.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 143, "Accounting for Asset Retirement Obligations," which addresses accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. We adopted SFAS No. 143 during the quarter ended March 31, 2003. The adoption of SFAS No. 143 did not have a significant impact on our consolidated financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Exit or Disposal Activities." SFAS No. 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for under Emerging Issues Task Force, or EITF, No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The scope of SFAS No. 146 also includes costs related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. SFAS No. 146 was effective for exit or disposal activities initiated after December 31, 2002. We adopted SFAS No. 146 during the quarter ended March 31, 2003. The adoption of SFAS No. 146 did not have a significant impact on our consolidated financial statements. The effect of adoption of SFAS No. 146 will change on a prospective basis the timing of when restructuring charges are recorded from a commitment date approach to when the liability is incurred.

In November 2002, the FASB issued FASB Interpretation, or FIN, No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 requires that a liability

be recorded in the guarantor's balance sheet upon issuance of a guarantee. In addition, FIN No. 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity's product warranty liabilities. The initial recognition and initial measurement provisions of FIN No. 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements of FIN No. 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We adopted the disclosure provision of FIN No. 45 for the year ended December 31, 2002 and since December 31, 2002 the recognition and measurement provisions of FIN No. 45 has not had a material impact on our consolidated financial statements.

In November 2002, the EITF reached a consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently assessing the impact of EITF Issue No. 00-21 on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. We have chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the estimate of the market value of our stock at the date of the grant over the amount an employee must pay to acquire our stock. We have adopted the interim disclosure provisions for our financial reports for the quarter ended March 31, 2003. As the adoption of this standard involves disclosures only, we do not expect a material impact on our consolidated financial statements.

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN No. 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN No. 46 must be applied for the first interim or annual period beginning after June 15, 2003. We are currently reviewing our equity investments and associated relationships to determine if they are variable interest entities as defined by FIN No. 46. It is reasonably possible that we are the primary beneficiary of or hold a significant variable interest in a variable interest entity. The nature, purpose and activities of the potential variable interest entities is outlined in Note 13 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2002. Our maximum exposure to loss as a result of our involvement with the potential variable interest entities is our investment in such entities as we are not obligated to provide any additional financing.

Liquidity and Capital Resources

Operating activities.

Our operating activities generated cash of $15.1 million for the three months ended March 31, 2003 as compared to $10.3 million for the three months ended March 31, 2002. For the three months ended March 31, 2003, our primary sources of operating cash flow were the collection of an income tax refund of $14.4 million, collection of accounts receivable from related and unrelated parties and the timing of inventory purchases and payments to our vendors and service providers. We measure the effectiveness of our collections efforts by an analysis of average days sales outstanding. Days sales outstanding were 46 days in the first quarter of 2003 as compared to 64 days in the first quarter of 2002. Collections of accounts receivable and related days sales outstanding will fluctuate in future periods due to the timing and amount of our future revenues, customer payment terms and the effectiveness of our collection efforts.

Investing activities.

Our investing activities used cash of $7.8 million for the first quarter of 2003 as compared to $8.2 million for the first quarter of 2002. Investing activities in the first

quarter of 2003 were primarily related to net purchases of available-for-sale and equity investments of $7.2 million and capital expenditures of $513,000. Investing activities in the first quarter of 2002 were primarily related to net purchases of available-for-sale investments of $6.9 million and capital expenditures of $1.3 million.

Financing activities.

Our financing activities provided cash of $1.8 million both during the first quarters of 2002 and 2003. Cash generated from financing activities primarily related to issuance of common stock under the employee stock purchase plan and the exercise of employee stock options totaling $2.0 million and $1.8 million in the first quarters of 2002 and 2003, respectively.

Principal sources of liquidity at March 31, 2003 consisted of $168.1 million of cash, cash equivalents, and short-term and long-term available-for-sale investments. In July 2002, we posted a bond in the amount of $36.5 million for the Atmel litigation. In connection with the bond, we have pledged cash, cash equivalents and available-for-sale investments in the amount of $36.5 million. As of March 31, 2003, this amount is included in restricted cash, cash equivalents and available-for-sale investments in our balance sheet.

Purchase Commitments.

As of March 31, 2003, we had outstanding purchase commitments with our foundry vendors of $25.9 million for delivery in 2003. We have recorded a liability of $1.4 million for adverse purchase commitments.

Lease Commitments. We have long-term, non-cancelable building lease commitments. We are currently seeking subtenants for our unused office space. During the third quarter of 2001, we recorded a period charge to other operating expense of $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge was an estimate and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. We may be unable to secure subtenants for this space due to the recent decrease in demand for commercial rental space in Silicon Valley. If we are not successful in subleasing our unused office space, we may be required to take an additional period charge for the balance of the future lease cost. At December 31, 2002 and March 31, 2003, payments made have reduced the recorded liability to $473,000 and $425,000, respectively. See also "Business Risks - If we are not successful in subleasing our unused office space, we may be required to take a period charge for the difference between the total future sublease income and our lease cost."

Future payments due under building lease, purchase commitments and other contractual obligations as of March 31, 2003 (in thousands):

Contractual obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Notes payable................	$ 1,139	$ 362	$ 777	$ --	$ --
Operating leases............	23,823	5,150	8,175	5,045	5,453
Purchase commitments.........	25,853	25,853	--	--	--
Other long-term liability....	1,232	--	629	218	385
Total.......................	$ 52,047	$ 31,365	$ 9,581	$ 5,263	$ 5,838

Stock Purchase Plan. In September 2001, our board of directors authorized the purchase of an aggregate of up to $15.0 million of our common stock. The purchases may be made in the open market at prevailing market prices or in negotiated transactions off the market, subject to compliance with applicable provisions of the California Corporations Code and in accordance with applicable federal and state securities laws and regulations. The stock purchase program was extended until October 31, 2003 and will stay in effect unless earlier revoked by our board of directors. As of March 31, 2003, no shares had been purchased under this program.

Operating Capital Requirements. We believe that our cash balances, together with the funds we expect to generate from operations, will be sufficient to meet our projected working capital and other cash requirements through at least the next twelve months. However, there can be no assurance that future events will not require us to seek additional borrowings or capital and, if so required, that such borrowing or capital will be available on acceptable terms. Factors that could affect our short-term and long-term cash used or generated from operations and as a result, our need to seek additional borrowings or capital include:

- the average selling prices of our products;

- customer demand for our products;
- the need to secure future wafer production capacity from our suppliers;
- the timing of significant orders and of license and royalty revenue; and
- unanticipated research and development expenses associated with new product introductions.

Please also see "Business Risks - Our operating results fluctuate significantly, and an unanticipated decline in revenues may disappoint securities analyst or investors and result in a decline in our stock price."

In addition, on May 7, 2002, the court entered judgment against us in Atmel's lawsuit against us in the total amount of $36.5 million. In the event our appeal of this lawsuit is unsuccessful, we may have to pay this amount to Atmel. For more information, please also see "Business Risks - If we are accused of infringing the intellectual property rights of other parties we may become subject to time-consuming and costly litigation. If we lose, we could suffer a significant impact on our business and be forced to pay damages."

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance the Atmel complaint or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of March 31, 2003.

Business Risks

Risks Related to Our Business

Our operating results fluctuate significantly, and an unanticipated decline in revenues may disappoint securities analysts or investors and result in a decline in our stock price.

Although we were profitable in 2000, we incurred net losses for 2001, 2002 and first quarter of 2003, and in fiscal 1998 and 1999. Our operating results have fluctuated significantly and our past financial performance should not be used to predict future operating results. Our recent quarterly and annual operating results have fluctuated, and may continue to fluctuate, due to the following factors, all of which are difficult to forecast and many of which are out of our control:

- the availability, timely delivery and cost of wafers or other manufacturing and assembly services from our suppliers;
- competitive pricing pressures and related changes in selling prices;
- fluctuations in manufacturing yields and significant yield losses;
- new product announcements and introductions of competing products by us or our competitors;
- product obsolescence;
- lower of cost or market, obsolescence or other inventory adjustments;
- changes in demand for, or in the mix of, our products;
- the gain or loss of significant customers;
- market acceptance of products utilizing our SuperFlash® technology;
- changes in the channels through which our products are distributed and the timeliness of receipt of distributor resale information;
- exchange rate fluctuations;
- general economic, political and environmental-related conditions, such as natural disasters;
- increases in allowance for doubtful accounts;
- valuation allowances on deferred tax assets based on changes in estimated future taxable income;
- difficulties in forecasting, planning and management of inventory levels;
- unanticipated research and development expenses associated with new product introductions; and
- the timing of significant orders and of license and royalty revenue.

As recent experience confirms, a downturn in the market for products such as personal computers and cellular telephones that incorporate our products can also harm our operating results.

Our operating expenses are relatively fixed, and we order materials in advance of anticipated customer demand. Therefore, we have limited ability to reduce expenses quickly in response to any revenue shortfalls.

Our operating expenses are relatively fixed, and we therefore have limited ability to reduce expenses quickly in response to any revenue shortfalls. Consequently, our operating results will be harmed if our revenues do not meet our projections. We may experience revenue shortfalls for the following reasons:

- sudden drops in consumer demand which may cause customers to cancel backlog, push out shipment schedules, or reduce new orders, possibly due to a slowing economy or inventory corrections among our customers;
- significant declines in selling prices that occur because of competitive price pressure during an over-supply market environment;
- sudden shortages of raw materials for fabrication, test or assembly capacity constraints that lead our suppliers to allocate available supplies or capacity to other customers which, in turn, harm our ability to meet our sales obligations; and

- the reduction, rescheduling or cancellation of customer orders.

In addition, political or economic events beyond our control can suddenly result in increased operating costs. For example, the terrorist attacks of September 11, 2001 have resulted in a substantial increase to our business insurance costs. In addition, there is considerable public debate as to whether to require companies to record compensation expense on stock option grants. Such requirements, if enacted, would substantially increase our operating costs and impact our earnings (loss) per share.

We incurred significant inventory valuation adjustments in 2001 and 2002 and we may incur additional significant inventory valuation adjustments in the future.

We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. As of March 31, 2003, we had $68.6 million of inventory on hand, a decrease of $14.4 million, or 17.4%, from December 31, 2002. Total valuation adjustments to inventory were $72.2 million in 2001, $9.2 million in 2002 and $2.4 million in the first quarter of 2003. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and could harm our financial results. Some of our customers have requested that we ship them product that has a finished goods date of manufacture that is less than one year old. As of March 31, 2003, our allowance for excess and obsolete inventories includes an allowance for our on hand finished goods inventory with a date of manufacture of greater than two years old and for certain products with a date of manufacture of greater than one year old. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on hand finished goods inventory with a date of manufacture of greater than one year old, which could result in a significant adjustment and could harm our financial results.

Cancellations or rescheduling of backlog may result in lower future revenue and harm our business.

Due to possible customer changes in delivery schedules and cancellations of orders, our backlog at any particular date is not necessarily indicative of actual sales for any succeeding period. A reduction of backlog during any particular period, or the failure of our backlog to result in future revenue, could harm our business. We began to experience a sharp downturn in several of our markets late in the fourth quarter of 2000, as our customers reacted to weakening demand for their products. Although we had improvements in total units shipped since the second quarter of 2002, our revenues declined in first quarter of 2003 when compared to first quarter of 2002 due to decreased average selling prices. Our business could be harmed by industry-wide fluctuations in the future.

Our business may suffer due to risks associated with international sales and operations.

During 2001, 2002 and first quarter of 2003, our export product and licensing revenues accounted for 90.3%, 92.0% and 93.0% of our net revenues, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would harm our operating results. These risks include:

- difficulties in complying with regulatory requirements and standards;
- tariffs and other trade barriers;
- costs and risks of localizing products for foreign countries;
- reliance on third parties to distribute our products;
- extended accounts receivable payment cycles;
- potentially adverse tax consequences;
- limits on repatriation of earnings; and
- burdens of complying with a wide variety of foreign laws.

In addition, we have made equity investments in companies with operations in China, Japan and Taiwan. The value of our investments is subject to the economic and political conditions particular to their industry, their countries and to the global economy. If we determine that a change in the recorded value of an investment is other than temporary, we will adjust the value of the investment. Such an expense could have a negative impact on our operating results. During 2002 we determined that a decline in the value of our investment in Apacer was other than temporary and we wrote down the value of our investment by $7.8 million.

We derived 80.7%, 88.5% and 89.6% of our net product revenues from Asia during 2001, 2002 and first quarter of 2003, respectively. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia. Any kind of economic, political or environmental instability in this region of the world can have a severe negative impact on our operating results due to the large concentration of our production and sales activities in this region. For example, during 1997 and 1998, several Asian countries where we do business, such as Japan, Taiwan and Korea, experienced severe currency fluctuation and economic deflation, which negatively impacted our revenues and also negatively impacted our ability to collect payments from customers. During this period, the lack of capital in the financial sectors of these countries made it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks. Finally, the economic situation during this period exacerbated a decline in selling prices for our products as our competitors

reduced product prices to generate needed cash.

It should also be noted that we are greatly impacted by the political, economic and military conditions in Taiwan. Taiwan and China are continuously engaged in political disputes and both countries have continued to conduct military exercises in or near the other's territorial waters and airspace. Such disputes may continue and even escalate, resulting in an economic embargo, a disruption in shipping or even military hostilities. Any of these events could delay production or shipment of our products. Any kind of activity of this nature or even rumors of such activity could harm our operations, revenues, operating results, and stock price.

Terrorist attacks and threats, and government responses thereto, could harm our business.

Terrorist attacks in the United States or abroad against American interests or citizens, U.S. retaliation for these attacks, threats of additional terrorist activity and the war in Iraq has caused our customer base to become more cautious. Any escalation in these events or similar future events may disrupt our operations or those of our customers, distributors and suppliers, and may affect the availability of materials needed to manufacture our products or the means to transport those materials to manufacturing facilities and finished products to customers. In addition, these events have had and may continue to have an adverse impact on the U.S. and world economy in general and consumer spending in particular, which could harm our business.

We do not typically enter into long-term contracts with our customers, and the loss of a major customer could harm our business.

We do not typically enter into long-term contracts with our customers. In addition, we cannot be certain as to future order levels from our customers. In the past, when we have entered into a long-term contract, the contract has generally been terminable at the convenience of the customer.

We depend on stocking representatives and distributors to generate a majority of our revenues.

We rely on stocking representatives and distributors to establish and maintain customer relationships and to sell our products. These stocking representatives and distributors could discontinue their relationship with us or discontinue selling our products at any time. The majority of our stocking representatives are located in Asia. The loss of our relationship with any stocking representative or distributor could harm our operating results by impairing our ability to sell our products to our end customers.

We depend on SPT, our logistics center, to support many of our customers in Asia.

Since March 2001, we have been increasing our out-sourcing activities with our customer service logistics to support our customers. Currently SPT supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly-owned subsidiary of one of our stocking representatives in Taiwan, PCT. During 2001, 2002 and first quarter of 2003, SPT serviced end customer shipments accounted for 29.7%, 57.4% and 65.0% of our net product revenues recognized, respectively. For further description of our relationships with PCT and SPT, please refer to " Management's Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2002.

We do not have any long-term contracts with SPT or PCT, and SPT or PCT may cease providing services to us at any time. If SPT or PCT were to terminate their relationship with us, we would experience a delay in reestablishing warehousing, logistics and distribution functions, which could impair our ability to collect accounts receivable from SPT and may harm our business.

We depend on a limited number of foreign foundries to manufacture our products, and these foundries may not be able to satisfy our manufacturing requirements, which could cause our revenues to decline.

We outsource substantially all of our manufacturing and testing activities. We currently buy all of our wafers and sorted die from a limited number of suppliers. Substantially all of our products are manufactured by five foundries, Taiwan Semiconductor Manufacturing Co., Ltd., or TSMC, in Taiwan, Sanyo, Seiko-Epson and Yasu Semiconductor in Japan, and Samsung in Korea. We anticipate that these foundries, together with Vanguard in Taiwan will manufacture the majority of our products in 2003. In March 2001, we invested $50.0 million in Grace Semiconductor Manufacturing Corporation, or GSMC, a Cayman Islands company, for a wafer foundry project located in Shanghai, China. We anticipate that GSMC will begin to manufacture some of our products in the second half of 2003. If these suppliers fail to satisfy our requirements on

a timely basis at competitive prices we could suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of which could harm our operating results.

Our revenues may be impacted by our ability to obtain adequate wafer supplies from our foundries. The foundries with which we currently have arrangements, together with any additional foundry at which capacity might be obtained, may not be willing or able to satisfy all of our manufacturing requirements on a timely basis at favorable prices. In addition, we have encountered delays in qualifying new products and in ramping-up new product production and we could experience these delays in the future. We are also subject to the risks of service disruptions, raw material shortages and price increases by our foundries. Such disruptions, shortages and price increases could harm our operating results.

Manufacturing capacity has in the past been difficult to secure and if capacity constraints arise in the future our revenues may decline.

In order to grow, we need to increase our present manufacturing capacity. We currently believe that the existing capacity available to us will be sufficient through 2003. However, events that we have not foreseen could arise which would limit our capacity. Similar to our $50.0 million investment in GSMC, we may determine that it is necessary to invest substantial capital in order to secure appropriate production capacity commitments. If we cannot secure additional manufacturing capacity on acceptable terms, our ability to grow will be impaired and our operating results will be harmed.

If we are not successful in subleasing our unused office space, we may be required to take a period charge for the difference between the total future sublease income and our lease cost.

We have long-term, non-cancelable building lease commitments. We are currently in the process of locating subtenants for our unused office space. We may be unable to secure subtenants for this space due to the recent decrease in demand for commercial rental space in Silicon Valley. During the third quarter of 2001, we recorded a period charge to other operating expense of $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge was an estimate and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. If we are unable to secure subtenants, we may be required to take additional period charges for the balance of the future lease cost, and this will harm our operating results.

Our cost of revenues may increase if we are required to purchase manufacturing capacity in the

future.

To obtain additional manufacturing capacity, we may be required to make deposits, equipment purchases, loans, joint ventures, equity investments or technology licenses in or with wafer fabrication companies. These transactions could involve a commitment of substantial amounts of our capital and technology licenses in return for production capacity. We may be required to seek additional debt or equity financing if we need substantial capital in order to secure this capacity and we cannot assure you that we will be able to obtain such financing.

If our foundries fail to achieve acceptable wafer manufacturing yields, we will experience higher costs of revenues and reduced product availability.

The fabrication of our products requires wafers to be produced in a highly controlled and ultra-clean environment. Semiconductor companies that supply our wafers from time to time have experienced problems achieving acceptable wafer manufacturing yields. Semiconductor manufacturing yields are a function of both our design technology and the foundry's manufacturing process technology. Low yields may result from marginal design or manufacturing process drift. Yield problems may not be identified until the wafers are well into the production process, which often makes them difficult, time consuming and costly to correct. Furthermore we rely on independent foundries for our wafers which increases the effort and time required to identify, communicate and resolve manufacturing yield problems. If our foundries fail to achieve acceptable manufacturing yields, we will experience higher costs of revenues and reduced product availability, which could harm our operating results.

If our foundries discontinue the manufacturing processes needed to meet our demands, or fail to upgrade the technologies needed to manufacture our products, we may face production delays and lower revenues.

Our wafer and product requirements typically represent a small portion of the total production of the foundries that manufacture our products. As a result, we are subject to the risk that a foundry will cease production on an older or lower-volume manufacturing process that it uses to produce our parts. Additionally, we cannot be certain our foundries will continue

to devote resources to advance the process technologies on which the manufacturing of our products is based. Each of these events could increase our costs and harm our ability to deliver our products on time.

Our dependence on third-party subcontractors to assemble and test our products subjects us to a number of risks, including an inadequate supply of products and higher costs of materials.

We depend on independent subcontractors to assemble and test our products. Our reliance on these subcontractors involves the following significant risks:

- reduced control over delivery schedules and quality;
- the potential lack of adequate capacity during periods of strong demand;
- difficulties selecting and integrating new subcontractors;
- limited warranties on products supplied to us;
- potential increases in prices due to capacity shortages and other factors; and
- potential misappropriation of our intellectual property.

These risks may lead to increased costs, delayed product delivery or loss of competitive advantage, which would harm our profitability and customer relationships.

Because our flash memory products typically have lengthy sales cycles, we may experience substantial delays between incurring expenses related to research and development and the generation of revenues.

Due to the flash memory product cycle we usually require more than nine months to realize volume shipments after we first contact a customer. We first work with customers to achieve a design win, which may take three months or longer. Our customers then complete the design, testing and evaluation process and begin to ramp up production, a period which typically lasts an additional six months or longer. As a result, a significant period of time may elapse between our research and development efforts and our realization of revenue, if any, from volume purchasing of our products by our customers.

We face intense competition from companies with significantly greater financial, technical and marketing resources that could harm sales of our products.

We compete with major domestic and international semiconductor companies, many of which have substantially greater financial, technical, marketing, distribution, and other resources than we do. Many of our competitors have their own facilities for the production of semiconductor memory components and have recently added significant capacity for such production. Our memory products, which presently account for substantially all of our revenues, compete principally against products offered by AMD, Atmel, Intel, Macronix, Sanyo, STMicroelectronics and Winbond. If we are successful in developing our high-density products, these products will compete principally with products offered by AMD, Atmel, Fujitsu, Hitachi, Intel, Mitsubishi, Samsung, SanDisk, Sharp Electronics, STMicroelectronics and Toshiba, as well as any new entrants to the market.

In addition, we may in the future experience direct competition from our foundry partners. We have licensed to our foundry partners the right to fabricate products based on our technology and circuit design, and to sell such products worldwide, subject to our receipt of royalty payments.

Competition may also come from alternative technologies such as ferroelectric random access memory devices, or FRAM, or other developing technologies.

Our markets are subject to rapid technological change and, therefore, our success depends on our ability to develop