

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

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

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FORM 10-Q

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

For the quarterly period ended September 30, 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**

(State or Other Jurisdiction of Incorporation or Organization)

**77-0225590**

(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 such 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, October 31, 2003: 95,134,412.

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Silicon Storage Technology, Inc.  
FORM 10-Q: QUARTER ENDED SEPTEMBER 30, 2003  
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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 September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net revenues:				
Product revenues - unrelated parties.....	\$ 21,712	\$ 21,069	\$ 81,587	\$ 58,950
Product revenues - related parties.....	37,733	44,328	105,633	115,228
Technology licensing.....	8,311	8,538	24,595	25,646
Total net revenues.....	67,756	73,935	211,815	199,824
Cost of revenues:				
Cost of revenues - unrelated parties.....	19,033	17,953	65,892	53,300
Cost of revenues - related parties.....	30,367	37,641	84,245	102,728
Total cost of revenues.....	49,400	55,594	150,137	156,028
Gross profit.....	18,356	18,341	61,678	43,796
Operating expenses:				
Research and development.....	11,955	10,746	35,746	32,810
Sales and marketing.....	5,083	5,300	19,106	16,432
General and administrative.....	3,086	3,207	14,257	10,288
Other.....	--	36,478	--	36,478

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Total operating expenses.....	20,124	55,731	69,109	96,008
Loss from operations.....	(1,768)	(37,390)	(7,431)	(52,212)
Interest and other income.....	670	1,330	2,545	2,364
Interest expense.....	(41)	(30)	(171)	(109)
Other expense.....	(7,757)	--	(7,757)	--
Loss before provision for (benefit from) income taxes.	(8,896)	(36,090)	(12,814)	(49,957)
Provision for (benefit from) income taxes.....	(4,128)	22,928	(5,382)	24,315
Net loss.....	\$ (4,768)	\$ (59,018)	\$ (7,432)	\$ (74,272)
Net loss per share - basic and diluted.....	\$ (0.05)	\$ (0.62)	\$ (0.08)	\$ (0.79)
Shares used in per share calculation - basic and diluted.....	93,037	95,002	92,492	94,553

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	September 30, 2003
	(unaudited)	(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 103,751	\$ 129,097
Short-term available-for-sale investments.....	41,252	36,743
Trade accounts receivable-unrelated parties, net of allowance for doubtful accounts of \$4,420 at December 31, 2002 and \$4,364 at September 30, 2003.....	10,723	8,831
Trade accounts receivable-related parties.....	25,248	35,565
Inventories.....	83,040	48,762
Deferred tax assets.....	17,154	--
Other current assets.....	29,671	14,176
Total current assets.....	310,839	273,174
Equipment, furniture and fixtures, net.....	16,989	12,302
Long-term available-for-sale investments.....	5,862	31,149
Restricted cash and cash equivalents.....	11,976	18,823
Restricted available-for-sale investments.....	24,873	18,388
Equity investments.....	60,910	55,629
Other assets.....	9,157	1,879

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Total assets.....	\$	440,606	\$	411,344
<b>LIABILITIES</b>				
Current liabilities:				
Notes payable, current portion.....	\$	352	\$	382
Trade accounts payable-unrelated parties.....		28,408		24,281
Trade accounts payable-related parties.....		6,689		7,016
Accrued expenses and other liabilities.....		18,783		47,941
Deferred revenue.....		2,650		6,020
Total current liabilities.....		56,882		85,640
Other liabilities.....		1,873		1,625
Total liabilities.....		58,755		87,265
Commitments (Note 7) and Contingencies (Note 8)				
<b>SHAREHOLDERS' EQUITY</b>				
Common stock, no par value:				
Authorized: 250,000 shares				
Issued and outstanding: 93,295 shares at December 31, 2002				
and 95,107 shares at September 30, 2003.....				
		339,598		344,517
Accumulated other comprehensive income.....		151		11,732
Retained earnings (accumulated deficit).....		42,102		(32,170)
Total shareholders' equity.....		381,851		324,079
Total liabilities and shareholders' equity.....	\$	440,606	\$	411,344

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)

	Nine Months Ended September 30,	
	2002	2003
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net loss.....	\$ (7,432)	\$ (74,272)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization.....	7,512	5,995
Provision (credit) for doubtful accounts receivable.....	3,178	(56)

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Provision (credit) for sales returns.....	1,315	(356)
Provision for excess and obsolete inventories, write-down of inventories and adverse purchase commitments.....	6,793	6,234
Other expenses.....	7,757	--
Deferred income taxes.....	5,804	22,318
Tax benefit from employee stock plans	--	1,251
Net (gain) loss on disposal of equipment.....	(93)	114
Gain on sale of equity investments.....	--	(649)
Changes in operating assets and liabilities:		
Trade accounts receivable-unrelated parties.....	778	2,304
Trade accounts receivable-related parties.....	(4,650)	(10,317)
Inventories.....	8,539	27,907
Other current and non-current assets.....	(7,019)	17,609
Trade accounts payable-unrelated parties.....	6,042	(4,127)
Trade accounts payable-related parties.....	459	327
Accrued expenses and other liabilities.....	(4,935)	29,094
Deferred revenue.....	(1,816)	3,370
	-----	-----
Net cash provided by operating activities.....	22,232	26,746
	-----	-----
Cash flows from investing activities:		
Investment in equity securities.....	(1,324)	--
Acquisition of equipment, furniture and fixtures.....	(3,438)	(1,082)
Purchases of available-for-sale investments and restricted cash and cash equivalents.....	(63,087)	(35,087)
Sales and maturities of available-for-sale and equity investments.	56,002	31,362
	-----	-----
Net cash used in investing activities.....	(11,847)	(4,807)
	-----	-----
Cash flows from financing activities:		
Debt repayments.....	(234)	(261)
Issuance of shares of common stock.....	3,972	3,668
Other.....	(107)	--
	-----	-----
Net cash provided by financing activities.....	3,631	3,407
	-----	-----
Net increase in cash and cash equivalents.....	14,016	25,346
Cash and cash equivalents at beginning of period.....	93,598	103,751
	-----	-----
Cash and cash equivalents at end of period.....	\$ 107,614	\$ 129,097
	=====	=====

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT SEPTEMBER 30, 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 financial statements in our Annual Report on Form 10-K for the year ended December 31, 2002 and the Quarterly Reports on Form 10-Q for the three months ended March 31, 2003 and the three and six months ended June 30, 2003.

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.

#### 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 has not had a material 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 is effective for exit or disposal activities that are 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 material impact on our consolidated financial statements. The effect on 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 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 SFAS 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 adopted the interim disclosure provisions for our financial reports beginning for the quarter ended March 31, 2003. As the adoption of this standard involves disclosures only, the adoption of SFAS No. 148 did not have 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. On October 8, 2003, the FASB decided to allow public entities to defer the effective date for applying the provisions of FIN No. 46, for variable interest entities created or acquired prior to February 1, 2003, until the end of the first interim or annual period ending after December 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 each such entity as we are not obligated to provide any additional financing.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first fiscal period beginning after June 15, 2003. SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still existing at the beginning of the interim period of adoption. Restatement is not permitted. We believe that the adoption of this standard will not have a material impact on our consolidated financial statements.

## 2. Other Expense



There were no charges to other expense for the three and nine months ended September 30, 2003. In 2000, we acquired a 10.0% interest in Apacer Technology, Inc., or Apacer, a privately held company located in Taiwan that designs, manufactures and markets memory modules, for \$9.9 million in cash. Our investment in Apacer was valued at cost. Bing Yeh, our President and CEO and a member of our Board of Directors, is a member of Apacer's Board of Directors. In 2001, we invested an additional \$2.1 million in Apacer. In August 2002, we made an additional investment of \$181 thousand. At the end of the third quarter of 2002, we determined that a continued and significant decline in Apacer's price per share was other than temporary, and accordingly, in the third quarter of 2002, we recorded a period charge to other expense of \$7.8 million to write down our investment in Apacer to \$4.4 million which was determined using the price per share paid for the additional investment in August 2002.

### 3. Computation of Net Loss Per Share

We have computed and presented net loss per share under two methods, basic and diluted. Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss

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per share is computed by dividing net 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 loss per share is as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Numerator - basic and diluted				
Net loss.....	\$ (4,768)	\$ (59,018)	\$ (7,432)	\$ (74,272)
Denominator - basic and diluted				
Weighted average common stock outstanding.....	93,037	95,002	92,492	94,553
Basic and diluted net loss per share.....	\$ (0.05)	\$ (0.62)	\$ (0.08)	\$ (0.79)

Stock options to purchase 10,069,000 and 9,537,200 shares of common stock were outstanding as of September 30, 2002 and 2003 with weighted average exercise prices of \$7.70 and \$7.61, respectively. These stock options were not included in the computation of diluted net loss per share for the three and nine months ended September 30, 2002 and 2003 because we had net losses for these periods, and therefore, their impact would be anti-dilutive.

## 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 loss and net loss per share for the three and nine months ended September 30, 2002 and 2003 would have been increased as indicated below (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Net loss, as reported.....	\$ (4,768)	\$ (59,018)	\$ (7,432)	\$ (74,272)
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects.....	(3,014)	(1,675)	(9,394)	(5,131)
Pro forma net loss.....	\$ (7,782)	\$ (60,693)	\$ (16,826)	\$ (79,403)
Pro forma net loss per share - basic and diluted.....	\$ (0.08)	\$ (0.64)	\$ (0.18)	\$ (0.84)

## 4. Restricted Cash,

**Cash Equivalents and Available-for-Sale Investments**

In July 2002, in connection with our Atmel litigation (see Note 8 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, cash equivalents and available-for-sale investments. As of September 30, 2003, total restricted cash, cash equivalents and available-for-sale investments was \$37.2 million, which consisted of the bond amount of \$36.5 million and restricted interest earned on the investments of \$733 thousand.

## 5. 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 for the three and nine months ended September 30, 2003 were not material.

King Yuan Electronics Company Limited, or KYE, Insyde Software Corporation, or Insyde, Powertech Technology, Incorporated, or PTI, and Professional Computer Technology Limited, or PCT, are Taiwanese companies that are listed on the Taiwan Stock Exchange. 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 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 September 30, 2003 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
	-----	-----	-----	-----
Corporate bonds and notes.....	\$ 208	\$ --	\$ --	\$ 208
Government bonds and notes.....	160,357	39	--	160,396
Foreign listed equity securities.....	6,206	11,847	(154)	17,899
	-----	-----	-----	-----
Total bonds, notes and equity securities....	\$ 166,771	\$ 11,886	\$ (154)	178,503
	=====	=====	=====	=====
Less amounts classified as cash equivalents.....				(92,223)
				-----
Total short and long-term available-for-sale investments.....				\$ 86,280
				=====
Contractual maturity dates for investments in bonds and notes:				
Less than 1 year.....				\$ 36,743
Less than 1 year - restricted.....				15,213
1 to 5 year.....				13,250
1 to 5 year - restricted.....				3,175
				-----
				\$ 68,381
				=====

The unrealized gains as of September 30, 2003 are recorded in accumulated other comprehensive income, net of tax of zero amount.

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

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	Amortized Cost	Unrealized Gain	Unrealized Loss	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 thousand.

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## 6. Balance Sheet Detail

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

Inventories comprise:

	December 31, 2002	September 30, 2003
	-----	-----
Raw materials.....	\$ 40,036	\$ 20,753
Work in process.....	8,923	10,133
Finished goods.....	28,608	12,167
Inventories held at logistics center.....	5,473	5,709
	-----	-----
	\$ 83,040	\$ 48,762
	=====	=====

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 material 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 material adjustment and could harm our financial results. As of September 30, 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 estimates could have a material impact on our financial position and results of operations.

Other current assets comprise:

	December 31, 2002	September 30, 2003
	-----	-----
Refundable income tax.....	\$ 22,744	\$ 6,042
Other current assets.....	6,927	8,134
	-----	-----
	\$ 29,671	\$ 14,176
	=====	=====

Accrued expenses and other liabilities comprise:

	December 31, 2002	September 30, 2003
	-----	-----
Accrued compensation and related items.....	\$ 5,070	\$ 4,094
Accrued income tax payable.....	6,782	663
Accrued liabilities-related parties.....	473	570
Accrued warranty.....	492	235
Atmel accrual.....	--	36,478
Other accrued liabilities.....	5,966	5,901
	-----	-----
	\$ 18,783	\$ 47,941
	=====	=====

## Accrued warranty:

Balance at December 31, 2002.....	\$	492
Accruals for warranties issued during the period.....		257
Settlements made during the period.....		(514)
		-----
Balance at September 30, 2003.....	\$	235
		=====

Our products are generally subject to warranty. 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, with an automatic renewal provision. Our current license agreements expire from 2004 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 \$38.5 million. We have not recorded any liabilities as of September 30, 2003 related to these indemnities.

During the 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.

## 7. Commitments

As of September 30, 2003, we had outstanding purchase commitments with our foundry vendors of \$43.1 million for delivery in 2003. We have recorded a liability of \$1.1 million for adverse purchase commitments.

During the third quarter of 2001, we recorded a period charge to other operating expense of \$756 thousand 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 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 September 30, 2003, payments made have reduced the recorded liability to \$473 thousand and \$322 thousand, respectively.

## 8. 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. 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.

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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 issued a Limited Exclusion Order, which 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. 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 September 12, 2003 the Federal Circuit issued a decision upholding the trial court verdict. We believe that the Federal Circuit's decision was erroneous and inconsistent with its precedent, and on September 25, 2003 we petitioned the Court to reconsider its decision. The Court asked Atmel to respond to our petition, and Atmel filed its Opposition on October 21, 2003. The Court may affirm or reverse its decision without further input from the parties, or it may ask for further briefing or argument from the parties. 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 September 30, 2003, this amount is included in restricted cash, cash equivalents and available-for-sale investments in

our balance sheet (see Note 4 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 appeal of the verdict regarding the '811 and '829 patents is finally 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. In the third quarter of 2003, we recorded a \$36.5 million liability due to an increased probability of a loss in the Atmel litigation, based on the most recent judgement in this litigation. The expense is shown in the condensed consolidated statements of operations as other operating expense. As for other legal actions that may arise in the ordinary course of business, 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 other than the potential losses related to Atmel have been accrued in our financial statements as of September 30, 2003.

## 9. 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 Multi-Purpose Flash, or MPF, family, the Multi-Purpose Flash Plus, 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. Effective July 1, 2003, we transferred the Small Sector Flash, or SSF, family from SMPG to SPG. Accordingly, our segment revenues and gross profit information have been reclassified for presentation purposes as if the transfers 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 segment revenues and gross



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profit information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002.

SPG includes ComboMemory, ROM/RAM Combos, SSF, 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. Effective July 1, 2003, we transferred the SSF family from SMPG to SPG. Accordingly, our segment revenues and gross profit 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 revenues and gross profit for each segment (in thousands):

	Three Months Ended September 30, 2002		Three Months Ended September 30, 2003	
	Revenues	Gross Profit	Revenues	Gross Profit
SMPG.....	\$ 37,507	\$ 1,354	\$ 44,798	\$ 5,479
ASPG.....	15,365	6,768	14,954	2,811
SPG.....	6,573	1,923	5,645	1,513
Technology Licensing.....	8,311	8,311	8,538	8,538
	<u>\$ 67,756</u>	<u>\$ 18,356</u>	<u>\$ 73,935</u>	<u>\$ 18,341</u>

	Nine Months Ended September 30, 2002		Nine Months Ended September 30, 2003	
	Revenues	Gross Profit	Revenues	Gross Profit
SMPG.....	\$ 112,298	\$ 10,634	\$ 116,058	\$ 9,151
ASPG.....	52,042	19,326	41,515	7,162
SPG.....	22,880	7,123	16,605	1,837
Technology Licensing.....	24,595	24,595	25,646	25,646
	<u>\$ 211,815</u>	<u>\$ 61,678</u>	<u>\$ 199,824</u>	<u>\$ 43,796</u>

## 10. Comprehensive Loss

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Net loss.....	\$ (4,768)	\$ (59,018)	\$ (7,432)	\$ (74,272)
Other comprehensive income:				
Change in net unrealized gains				

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on investments, net of tax.....	95	9,389	56	11,581
Total comprehensive loss.....	\$ (4,673)	\$ (49,629)	\$ (7,376)	\$ (62,691)

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

	December 31, 2002	September 30, 2003
Net unrealized gains on investments, net of tax.....	\$ 151	\$ 11,886
Net unrealized losses on investments, net of tax.....	--	(154)
	\$ 151	\$ 11,732

11. Related Party Transactions

The following table is a summary of our related party revenues and purchases for the three and nine months ended September 30, 2002 and 2003, and our related party accounts receivable and payable balances as of December 31, 2002 and September 30, 2003 (in thousands):

	Three Months Ended September 30, 2002		Three Months Ended September 30, 2003	
	Revenues	Purchases	Revenues	Purchases
Silicon Technology Co., Ltd.....	\$ 392	\$ --	\$ 1,024	\$ --
Ambit Microsystems Corp.....	45	--	--	--
Apacer Technology, Inc and related entities.	229	321	514	721
Silicon Professional Technology Ltd.....	37,067	--	42,790	--
King Yuan Electronics Company, Limited.....	--	4,111	--	4,722
Powertech Technology, Incorporated.....	--	1,399	--	2,251
	\$ 37,733	\$ 5,831	\$ 44,328	\$ 7,694

  

	Nine Months Ended September 30, 2002		Nine Months Ended September 30, 2003	
	Revenues	Purchases	Revenues	Purchases
Silicon Technology Co., Ltd.....	\$ 392	\$ --	\$ 1,024	\$ --
Ambit Microsystems Corp.....	45	--	--	--
Apacer Technology, Inc and related entities.	229	321	514	721
Silicon Professional Technology Ltd.....	37,067	--	42,790	--
King Yuan Electronics Company, Limited.....	--	4,111	--	4,722
Powertech Technology, Incorporated.....	--	1,399	--	2,251
	\$ 37,733	\$ 5,831	\$ 44,328	\$ 7,694

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Silicon Technology Co., Ltd.....	\$ 1,348	\$ --	\$ 2,889	\$ --
Ambit Microsystems Corp.....	269	--	--	--
Apacer Technology, Inc and related entities.	656	467	1,380	1,567
Professional Computer Technology Limited....	141	--	--	--
Silicon Professional Technology Ltd.....	103,219	--	110,959	--
King Yuan Electronics Company, Limited.....	--	13,677	--	13,039
Powertech Technology, Incorporated.....	--	6,151	--	6,447
	-----	-----	-----	-----
	\$ 105,633	\$ 20,295	\$ 115,228	\$ 21,053
	=====	=====	=====	=====

	December 31, 2002		September 30, 2003	
	Trade Accounts Receivable	Trade Accounts Payable and Accruals	Trade Accounts Receivable	Trade Accounts Payable and Accruals
Silicon Technology Co., Ltd.....	\$ 459	\$ --	\$ 421	\$ --
Apacer Technology, Inc and related entities.	141	119	402	475
Professional Computer Technology Limited....	--	73	--	78
Silicon Professional Technology Ltd.....	24,648	432	34,742	508
King Yuan Electronics Company, Limited.....	--	4,285	--	4,358
Powertech Technology, Incorporated.....	--	2,253	--	2,183
	-----	-----	-----	-----
	\$ 25,248	\$ 7,162	\$ 35,565	\$ 7,602
	=====	=====	=====	=====

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Professional Computer Technology Limited, or PCT, continues to earn commissions for point-of-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 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, the personnel costs required to maintain logistics and information technology functions and the costs to perform billing and collection of accounts receivable.

At the end of the third quarter of 2002, we determined that a continued and significant decline in Apacer's price per share was other than temporary, and accordingly, in the third quarter of 2002, we recorded a period charge to other expense of \$7.8 million to write down our investment in Apacer.

## 12. Income Taxes

We determined that based upon our historical losses and other available objective evidence that there is sufficient uncertainty regarding the realizability of our deferred tax assets such that a full valuation allowance was required. Accordingly, we recorded a valuation allowance against our deferred tax assets of \$45.3 million and associated adjustments to income tax payable during the third quarter of 2003.

## 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 cycle 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 experienced late in 2000 through 2001 have lasted for more than a year. We began to experience a slow recovery during 2002 through the first half of 2003. During the third quarter of 2003, demand for our products increased sharply and although we saw slight decreases in our average selling prices, the downward trend of average selling prices for many of our products has changed from prior quarters and we believe that the pricing environment may continue to gradually improve.

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 89.4% of our product revenues during 2001, 2002 and the nine months ended September 30, 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 38.2% of our net product revenues in 2001, 2002 and the nine months ended September 30,

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 nine months ended September 30, 2003.

Since March 2001, we have been increasing our out-sourcing activities with our customer service logistics to support our customers. 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 nine months ended September 30, 2003, SPT serviced end customer sales accounted for 57.4% and 63.7% of our net product revenues recognized, respectively. As of December 31, 2002 and September 30, 2003, SPT represented 68.5% and 78.3% of our net accounts receivable, respectively.

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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 net end customer sales in 2001, 2002 or the nine months ended September 30, 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 and Nine Months Ended September 30, 2003

##### Net Revenues

Net revenues were \$73.9 million for the third quarter of 2003 as compared to \$64.2 million in the second quarter of 2003 and \$67.8 million for the third quarter of 2002. Revenues for the third quarter of 2003 increased compared to the prior quarter primarily due to increased unit shipments, offset by decreased average selling prices for our products and decreased revenues from technology licensing. Revenues increased compared to the third quarter of last year due to increased unit shipments, offset by decreased average selling prices for our products. Our quarterly results are not indicative of annual results. 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. Net revenues were \$199.8 million for the nine months ended September 30, 2003 as compared to \$211.8 million for the

comparable period in 2002. The decrease from year to year was due to decreased average selling prices, offset by increased unit shipments.

#### Product Revenues

. Product revenues were \$65.4 million in the third quarter of 2003 as compared to \$54.9 million in the second quarter of 2003 and \$59.4 million for the third quarter of 2002. Product revenues increased compared to the second quarter of 2003 primarily due to increased unit shipments by 24.1%, offset by decreased average selling prices of our product by 3.6%. Product revenues increased compared to the third quarter of last year due to increased unit shipments by 32.9%, offset by decreased average selling prices for our products by 18.0%. Product revenues decreased to \$174.2 million in the first nine months of 2003 from \$187.2 million in the first nine months of 2002 due to decreased average selling prices by 19.2%, offset by increased unit shipments of our products of 14.2%. Unit shipments fluctuate due to overall industry supply and demand.

#### Technology Licensing Revenues.

Revenues from license fees and royalties were \$8.5 million in the third quarter of 2003, as compared to \$9.3 million in the second quarter of 2003 and \$8.3 million in the third quarter of 2002. The decrease in technology licensing revenues from the second quarter of 2003 to the third quarter of 2003 is due to decreased royalty from existing licensees, offset by increased license fees recognized. The increase in technology licensing revenues from the third quarter of 2002 to the third quarter of 2003 is due to increased royalty from existing licensees, offset by decreased license fees recognized. Revenues from license fees and royalties increased to \$25.6 million for the nine months ended September 30, 2003 from \$24.6 million for the comparable period in 2002. The period to period increase relates to increased royalty from existing licensees, offset by decreased license fees recognized.

#### Gross Profit

Gross profit was \$18.3 million, or 24.8% of net revenues, in the third quarter of 2003 as compared to gross profit of \$16.2 million, or 25.3% of net revenues, in the second quarter of 2003 and gross profit of \$18.4 million, or 27.1% of net revenues, in the third quarter of 2002. The increase in gross profit from the second quarter of 2003 to the third quarter of 2003 is due to increased unit shipments by 24.1%, offset by decreased technology licensing revenue by \$782 thousand and decreased average selling price of our products by 3.6%. The decrease in gross profit in the third quarter of 2003 when compared to the third quarter of 2002 is due to decreased average selling prices for our products by 18.0%, offset by increased unit shipments by 32.9% and increased technology licensing revenue by \$227 thousand. For the nine months ended September 30, 2003, gross profit was \$43.8 million, or 21.9% of net revenues, compared to \$61.7 million, or 29.1% of net revenues, for the comparable period in 2002. Product gross margin was 15.0% for the third quarter of 2003, compared to 12.6% for the second quarter of 2003 and 16.9% for the third quarter of 2002. The increase in product gross margin from the second quarter of 2003 to the third quarter of 2003 is due to increased unit shipments, changes in product mix and decreased costs

of production, offset by decreased average selling prices for our products. The decrease in product gross margin from the third quarter of 2002 to the third quarter of 2003 relates to decreased average selling prices of our products, offset by increased unit shipments. Product gross margin for the nine months ended September 30, 2003 decreased to 10.4%

from 19.8% for the comparable period in 2002. The period to period decrease was primarily due to decreased average selling prices and product mix. For other factors affecting our gross profit, please also see "Business Risks - We incurred material inventory valuation adjustments in 2001 and 2002 and we may incur additional material 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 \$55.7 million, or 75.4% of net revenues, in the third quarter of 2003, compared to \$20.0 million, or 31.1% of net revenues, in the second quarter of 2003, and \$20.1 million, or 29.7% of net revenues, in the third quarter of 2002. The increase from the second quarter of 2003 was primarily due to a \$36.5 million charge due to the increased probability of a loss in the litigation with Atmel and increases in engineering mask charges of \$648 thousand and logistic center fees of \$140 thousand, offset by decreased headcount related costs of \$1.1 million and depreciation expense of \$150 thousand. The increase from the third quarter of 2002 was primarily due to a \$36.5 million charge resulting from the increased probability of a loss in the on going litigation with Atmel and increases in bad debt expenses of \$794 thousand, patent related fees of \$271 thousand and commissions expenses of \$190 thousand, offset by decreases in Atmel related legal fees of \$663 thousand, headcount related costs of \$655 thousand and depreciation expense of \$370 thousand. Operating expenses increased to \$96.0 million for the nine months ended September 30, 2003 from \$69.1 million for the comparable period in 2002. The period to period increase was primarily due to a \$36.5 million charge due to the increased probability of a loss in the litigation with Atmel and increases in headcount related costs of \$444 thousand and logistic center fees of \$439 thousand, offset by decreases in bad debt expense of \$3.2 million, legal fees of \$2.1 million, engineering mask, wafer and evaluation expenses of \$1.9 million, depreciation and amortization expenses of \$1.1 million, commissions and logistic center expenses of \$936 thousand, outside service fees of \$448 thousand and travel expense of \$270 thousand. We anticipate that we will continue to devote substantial resources to research and development, sales and marketing and to general and administrative functions, and that these expenses may continue to increase.

### 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 masks, wafers and evaluation parts. Research and development expenses were \$10.7 million, or 14.5% of net revenues, during the third quarter of 2003, as compared to \$11.3 million, or 17.6% of net revenues, during the second quarter of 2003 and \$12.0 million, or 17.6% of net revenues, during the third quarter of 2002. Research and development expenses decreased by 5.0% from the second quarter of 2003 due primarily to decreases in headcount related costs of \$1.1 million, offset by increased engineering mask, wafer and evaluation expenses of \$536 thousand. Research and development expenses decreased by 10.1% from the third quarter of 2002 due primarily to decreases in headcount related costs of \$737 thousand, depreciation expense of \$236 thousand and engineering mask, wafer and evaluation expenses of \$269 thousand. For the nine months ended September 30, 2003, research and development expenses decreased to \$32.8 million from \$35.7 million for the comparable period in 2002. The period to period decrease was primarily due to decreases in engineering mask, wafer and evaluation expenses of \$1.9 million, depreciation expense of \$372 thousand, headcount related costs of \$351 thousand and outside service fees of \$347 thousand. We expect 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 and entertainment and promotional expenses. Sales and marketing expenses were \$5.3 million, or 7.2% of net revenues, in the third quarter of 2003, as compared to \$5.2 million, or 8.1% of net revenues, in the second quarter of 2003 and \$5.1 million, or 7.5% of net revenues, during the third quarter of 2002. The increase in sales and marketing expenses from

the second quarter of 2003 to the third quarter of 2003 by 2.4% was primarily attributable to increased logistic center fees for the current quarter of \$145 thousand primarily due to increased product revenues through our logistic center. The increase in sales and marketing expenses from the third quarter of 2002 to the third quarter of 2003 by 4.3% was primarily attributable to increases in costs related to the support of our patent and intellectual property of \$271 thousand and commissions and logistic center expenses of \$276 thousand, offset by decreases in headcount related costs of \$244 thousand. Sales and marketing expenses for the nine months ended September 30, 2003 were \$16.4 million as compared to \$19.1 million for the same period in 2002. The period to period decrease was primarily due to decreases in commissions and logistic center expenses of \$936 thousand and headcount related costs of \$1.0 million. 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.

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#### 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 \$3.2 million, or 4.3% of net revenues, in the third quarter of 2003, as compared to \$3.5 million, or 5.5% of net revenues, in the second quarter of 2003 and \$3.1 million, or 4.6% of net revenues, during the third quarter of 2002. The decrease in general and administrative expenses from the second quarter of 2003 by 8.4% was primarily due to decreased annual report costs by \$113 thousand. The increase in general and administrative expenses from the third quarter of 2002 was primarily due to increases in bad debt expenses of \$794 thousand and headcount related costs of \$326 thousand, offset by decreases in legal fees of \$688 thousand and depreciation expense of \$153 thousand. General and administrative expenses for the nine months ended September 30, 2003 were \$10.3 million as compared to \$14.3 million for the same period in 2002. The period to period decrease was primarily due to decreases in bad debt expenses of \$3.2 million as a result of a \$4.1 million charge that was recorded in the second quarter of 2002 related to the deteriorating financial condition of one customer and decreases in legal expenses of \$2.1 million and depreciation and amortization expenses of \$732 thousand, offset by and increases in headcount related expenses of \$1.8 million. We anticipate that general and administrative expenses may continue to 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 please also see "Part II, Item 1 - Legal Proceedings."

#### Other operating expense.

Other operating expense of \$36.5 million in the third quarter of 2003 was taken due to the increased probability of a loss in the Atmel litigation, based on the most recent judgement in this litigation. There were no comparable charges prior periods.

#### Interest and other income.

Interest and other income was \$1.3 million, or 1.8% of net revenues, during the third quarter of 2003, as compared to \$578 thousand, or 0.9% of net revenues, during the second quarter of 2003 and \$670 thousand, or 1.0% of net revenues, during the third quarter of 2002. Interest and other income increased from the second quarter of 2003 to the third quarter of 2003 and from the third quarter of 2002 to the third quarter of 2003, primarily due to gains of \$612 thousand on the sale of stock of one of our Taiwanese investments as a part of their initial public offering process and dividend income of \$369 thousand received from some of our equity investments. Interest and other income decreased to \$2.4 million for the nine months ended September 30, 2003 from \$2.5 million for the comparable period in 2002.



The decrease from period to period was due to decreasing interest rates on invested cash, offset by gains on the sale of stock of one of our investments in Taiwan as a part of their initial public offering process and dividend income received from some of our equity investments.

#### Interest expense.

Interest expense was \$30 thousand for the third quarter of 2003 as compared to \$41 thousand for the second quarter of 2003 and \$41 thousand for the third quarter of 2002. Interest expense decreased to \$109 thousand for the nine months ended September 30, 2003 from \$171 thousand for the comparable period in 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.

#### Other expense.

In 2000, we acquired a 10.0% interest in Apacer Technology, Inc., or Apacer, a privately held company located in Taiwan that designs, manufactures and markets memory modules, for \$9.9 million in cash. Our investment in Apacer was valued at cost. Bing Yeh, our President and CEO and a member of our Board of Directors, is a member of Apacer's Board of Directors. In 2001, we invested an additional \$2.1 million in Apacer. In August 2002, we made an additional investment of \$181 thousand. At the end of the third quarter of 2002, we determined that a continued and material decline in Apacer's price per share was other than temporary, and accordingly, in the third quarter of 2002, we recorded a period charge to other expense of \$7.8 million to write down our investment in Apacer to \$4.4 million which was determined using the price per share paid for the additional investment in August 2002.

#### Provision for (Benefit from) Income Taxes

In the third quarter of 2003, we determined that, based upon our historical losses and other available evidence, there is sufficient uncertainty regarding the realizability of our deferred tax assets such that a full valuation allowance was required. Accordingly, we recorded a valuation allowance against our deferred tax assets of \$45.3 million and associated adjustments to income tax payable, resulting in a tax expense of \$22.9 million. This compares with a tax expense of \$1.4 million in the second quarter of 2003 and with a tax benefit of \$4.1 million in the third quarter of 2002. Going forward, we will only record a tax expense as a result of foreign withholdings until such time that the valuation allowance against the deferred tax assets is no longer required.

#### Segment Reporting

Our operations involve the design, development, manufacturing, marketing and technical support of our nonvolatile memory technology and 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. Our reportable segments are: the Standard Memory Product Group, or SMPG, the Application Specific Product Group, or ASPG, the Special Product Group, or SPG, and Technology Licensing. Refer to Note 9 to the Condensed Consolidated Financial Statements for revenue and gross profit information by reportable segment. Our analysis of the changes for each segment is discussed

below.

SMPG includes our three standard flash memory product families: the Multi- Purpose Flash, or MPF, family, the Multi-Purpose Flash Plus, or MPF+, family, and the Many-Time Programmable, or MTP, family. Effective January 1, 2003, we transferred certain MTP products from SMPG to SPG. Effective July 1, 2003, we transferred the Small Sector Flash, or SSF, family from SMPG to SPG. Accordingly, our segment revenues and gross profit information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. SMPG revenues were \$44.8 million for the third quarter of 2003, as compared to \$36.8 million in the second quarter of 2003 and \$37.5 million in the third quarter of 2002. The increase in revenues from the second quarter of 2003 was primarily due to increases in unit shipments of our products by 24.3%, offset by a slight decrease in average selling prices by 0.9%. The increase in revenues from the third quarter of 2002 was primarily due to increased unit shipments of our products by 31.1%, offset by decreased average selling prices of 10.9%. For the nine months ended September 30, 2003, SMPG revenues were \$116.1 million, as compared to \$112.3 million for the comparable period in 2002. The period to period increase in revenues was primarily due to increased unit shipments of our products by 17.5%, offset by decreased average selling prices by 13.5%. Gross margin decreased from 14.0% in the second quarter of 2003 to 12.2% in the third quarter of 2003 primarily due to the decreased average selling prices and changes in product mix. Gross margin increased from 3.6% in the third quarter of 2002 to 12.2% in the third quarter of 2003 primarily due to the movement of previously reserved inventory, offset by decreased average selling price of our products. For the nine months ended September 30, 2003, gross margin was 7.9%, as compared to 9.5% for the comparable period in 2002. The period to period decrease in gross margin was primarily due to decreased average selling price of our product by 13.5% and changes in product mix.

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 segment revenues and gross profit information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. ASPG revenues were \$15.0 million for the third quarter of 2003, as compared to \$12.8 million in the second quarter of 2003 and \$15.4 million in the third quarter of 2002. The increase in revenues from the second quarter of 2003 was primarily due to increased unit shipments by 28.9%, offset by decreased average selling prices of our products by 11.9%. The decrease in revenue from the third quarter of 2002 was primarily due to decreased average selling price of our product by 34.3%, offset by increased unit shipments by 51.0%. For the nine months ended September 30, 2003, ASPG revenues were \$41.5 million, as compared to \$52.0 million for the comparable period in 2002. The period to period decrease in revenues was primarily due to decreased average selling prices by 32.4%, offset by increased unit shipments by 19.9%. Gross margin increased from 14.5% in the second quarter of 2003 to 18.8% in the third quarter of 2003 primarily due to changes in product mix. Gross margin decreased from 44.1% in the third quarter of 2002 to 18.8% in the third quarter of 2003 primarily due to decreased average selling price of our products and changes in product mix. For the nine months ended September 30, 2003, gross margin was 17.3%, as compared to 37.1% for the comparable period in 2002. The period to period decrease in gross margin was primarily due to decreased average selling prices and changes in product mix.

SPG includes ComboMemory, ROM/RAM Combos, SSF, MTP, flash microcontrollers 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. Effective July 1, 2003, we transferred the SSF family from SMPG to SPG. Accordingly, our segment revenue and gross profit information have been reclassified for presentation purposes as if the transfer occurred as of January 1, 2002. SPG revenues were \$5.6 million for the third quarter of 2003, as compared to \$5.3 million in the second quarter of 2003 and \$6.6 million in the third quarter of 2002. The increase in revenues from the second quarter of 2003 was primarily due to increased unit shipment of our product by 13.0%, offset by decreased average selling price by 1.9%. The decrease from the third quarter of 2002 was primarily due to decreased average selling prices by 23.6%, offset by increased unit shipments of our product by 13.2%. For the nine months ended September 30, 2003, SPG revenues were \$16.6 million, as compared to \$22.9 million for the comparable period in 2002. The period to period decrease in revenues was primarily due to decreased unit shipments

of our product by 11.8% and decreased average selling prices by 18.5%.

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Gross margin increased from negative 1.8% in the second quarter of 2003 to 26.8% in the third quarter of 2003 primarily due to the movement of previously reserved inventory. Gross margin decreased from 29.3% in the third quarter of 2002 to 26.8% in the third quarter of 2003. The decrease was primarily due to decreased average selling prices of our product. For the nine months ended September 30, 2003, gross margin was 11.1%, as compared to 31.1% for the comparable period in 2002. The period to period decrease in gross margin was primarily due to decreased average selling prices of our products and changes in product mix.

Revenue and gross profit related to Technology Licensing was \$8.5 million for the third quarter of 2003, \$9.3 million for the second quarter of 2003 and \$8.3 million for the third quarter of 2002. The decrease in technology licensing revenues from the second quarter of 2002 was due to decreased royalty from existing licensees, offset by increased license fees recognized. The increase in technology licensing revenues from the third quarter of 2002 to the third quarter of 2003 was due to increased royalty from existing licensees, offset by decreased license fees recognized. For the nine months ended September 30, 2003, revenue and gross profit related to Technology Licensing was \$25.6 million, as compared to \$24.6 million for the comparable period in 2002. The period to period increase was due to increased royalty from existing licensees, offset by decreased license fees recognized.

#### Related Party Transactions

The following table is a summary of our related party revenues and purchases for the quarter and nine months ended September 30, 2002 and 2003, and our related party accounts receivable and accounts payable and accruals as of December 31, 2002 and September 30, 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.

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	Three Months Ended September 30, 2002		Three Months Ended September 30, 2003	
	Revenues	Purchases	Revenues	Purchases
Silicon Technology Co., Ltd.....	\$ 392	\$ --	\$ 1,024	\$ --
Ambit Microsystems Corp.....	45	--	--	--
Apacer Technology, Inc and related entities.	229	321	514	721
Silicon Professional Technology Ltd.....	37,067	--	42,790	--
King Yuan Electronics Company, Limited.....	--	4,111	--	4,722
Powertech Technology, Incorporated.....	--	1,399	--	2,251

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	----- \$ 37,733 \$ 5,831 -----		----- \$ 44,328 \$ 7,694 -----	
	----- <b>Nine Months Ended September 30, 2002</b> -----		----- <b>Nine Months Ended September 30, 2003</b> -----	
	<b>Revenues</b>	<b>Purchases</b>	<b>Revenues</b>	<b>Purchases</b>
Silicon Technology Co., Ltd.....	\$ 1,348	\$ --	\$ 2,889	\$ --
Ambit Microsystems Corp.....	269	--	--	--
Apacer Technology, Inc and related entities.	656	467	1,380	1,567
Professional Computer Technology Limited....	141	--	--	--
Silicon Professional Technology Ltd.....	103,219	--	110,959	--
King Yuan Electronics Company, Limited.....	--	13,677	--	13,039
Powertech Technology, Incorporated.....	--	6,151	--	6,447
	-----	-----	-----	-----
	\$ 105,633	\$ 20,295	\$ 115,228	\$ 21,053
	-----	-----	-----	-----

  

	----- <b>December 31, 2002</b> -----		----- <b>September 30, 2003</b> -----	
	<b>Trade Accounts Receivable</b>	<b>Trade Accounts Payable and Accruals</b>	<b>Trade Accounts Receivable</b>	<b>Trade Accounts Payable and Accruals</b>
Silicon Technology Co., Ltd.....	\$ 459	\$ --	\$ 421	\$ --
Apacer Technology, Inc and related entities.	141	119	402	475
Professional Computer Technology Limited....	--	73	--	78
Silicon Professional Technology Ltd.....	24,648	432	34,742	508
King Yuan Electronics Company, Limited.....	--	4,285	--	4,358
Powertech Technology, Incorporated.....	--	2,253	--	2,183
	-----	-----	-----	-----
	\$ 25,248	\$ 7,162	\$ 35,565	\$ 7,602
	-----	-----	-----	-----

PCT continues to earn commissions for point-of-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 and accounts receivable, the personnel costs required to maintain logistics and information technology functions and the costs to perform billing and collection of accounts receivable.

At the end of the third quarter of 2002, we determined that a continued and material decline in Apacer's price per share was other than temporary, and accordingly, in the third quarter of 2002, we recorded a period charge to other expense of \$7.8 million to write down our investment in Apacer.

#### Liquidity and Capital Resources

##### Operating activities.

Our operating activities generated cash of \$22.2 million and \$26.7 million for the nine months ended September 30, 2002 and 2003, respectively. For the nine months ended September 30, 2003, our primary source of operating cash flow was the timing of inventory purchases and payments to our vendors and service providers. Cash generated from

operating activities included a decrease of \$27.9 million in inventories and non-cash adjustments of \$6.0 million related to

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depreciation and amortization, \$6.2 million related to provision for excess and obsolete inventories and a \$22.3 million decrease in deferred tax assets. Working capital uses of cash included a net loss of \$74.3 million, an increase in trade accounts receivable balances of \$8.0 million and a decrease in trade accounts payable balances of \$3.8 million. We measure the effectiveness of our collection efforts by an analysis of average days sales outstanding.

#### Investing activities.

Our investing activities used cash of \$11.8 million and \$4.8 million for the nine months ended September 30, 2002 and 2003, respectively. Investing activities in the nine months ended September 30, 2003 were primarily related to capital expenditures of \$1.1 million and net purchases of available-for-sale investments of \$3.7 million. Investing activities in the nine months ended September 30, 2002 were primarily related to capital expenditures of \$3.4 million and net purchases of available-for-sale investments and restricted cash of \$7.1 million. In addition, in the nine months ended September 30, 2002, we invested \$964 thousand in Insyde Software Corporation, a privately held Taiwanese company, and made additional investments of \$179 thousand in PCT and \$181 thousand in Apacer.

#### Financing activities.

Our financing activities provided cash of \$3.6 million and \$3.4 million during the nine months ended September 30, 2002 and 2003, respectively. Cash generated from financing activities primarily related to issuance of common stock under the employee stock purchase plan and the exercise of employee stock option totaling \$4.0 million and \$3.7 million in the nine months ended September 30, 2002 and 2003, respectively.

Principal sources of liquidity as of September 30, 2003 consisted of \$197.0 million of cash, cash equivalents, short 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 September 30, 2003, this amount is included in restricted cash, cash equivalents and available-for-sale investments in our balance sheet.

#### Purchase Commitments.

As of September 30, 2003, we had outstanding purchase commitments with our foundry vendors of \$43.1 million for delivery in 2003.

#### Lease Commitments.

We have long-term, non-cancelable building lease commitments. We are currently seeking 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. 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."

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Future payments due under building lease, purchase commitments and other contractual obligations as of September 30, 2003 (in thousands):

Contractual obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Notes payable.....	\$ 963	\$ 383	\$ 580	\$ --	\$ --
Operating leases.....	21,272	5,226	6,782	5,119	4,145
Purchase commitments.....	43,122	43,122	--	--	--
Other long-term liability....	1,045	--	433	192	420
Total.....	\$ 66,402	\$ 48,731	\$ 7,795	\$ 5,311	\$ 4,565

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 expired on October 31, 2003. No shares were purchased under this program.

Operating Capital Requirements.

We believe that our cash balances, together with the funds we expect to be generated 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 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 materially, 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 material

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 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. In the third quarter of 2003, we recorded a \$36.5 million liability based on the Atmel judgement due to the increased probability of a loss in this litigation. As for other legal actions that may arise in the ordinary course of business, 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 other than the losses related to Atmel have been accrued in our financial statements as of September 30, 2003.

#### Critical Accounting Policies

For information related to our revenue recognition and other critical accounting policies, please refer to the "Critical Accounting Policies" section of our 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.

#### 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 has not had a material 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 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 will be effective for exit or disposal activities that are 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 material impact on our consolidated financial statements. The effect on 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 SFAS 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 adopted the interim disclosure provisions for our financial reports beginning for the quarter ended March 31, 2003. As the adoption of this standard involves disclosures only, the adoption of SFAS No. 148 did not have 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. On October 8, 2003, the FASB decided to allow public entities to defer the effective date for applying the provisions of FIN No. 46, for variable interest entities created or acquired prior to February 1, 2003, until the end of the first interim or annual period ending after December 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 each such entity as we are not obligated to provide any additional financing.



In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first fiscal period beginning after June 15, 2003. SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still existing at the beginning of the interim period of adoption. Restatement is not permitted. We believe that the adoption of this standard will not have a material impact on our consolidated financial statements.

## Business Risks

### Risks Related to Our Business

Our operating results fluctuate materially, 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 in the first nine months 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, under a currently proposed standard, we would be required to record compensation expense on stock option grants and on shares purchased under our employee stock purchase program, which would substantially increase our operating costs and impact our earnings (loss) per share.

We incurred material inventory valuation adjustments in 2001 and 2002 and we may incur additional material 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 materially. 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 September 30, 2003, we had \$48.8 million of inventory on hand, a decrease of \$34.3 million, or 41.3%, from December 31, 2002. Total valuation adjustments to inventory were \$72.2 million in 2001, \$9.2 million in 2002 and \$5.6 million in the nine months ended September 30, 2003, of which \$761 thousand was recorded in the third 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 material 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 September 30, 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 material 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 in the future.

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

During 2001, 2002 and first nine months of 2003, our export product and licensing revenues accounted for 90.3%, 92.0% and 92.3% 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 foreign exchange rates and 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 89.4% of our net product revenues from Asia during 2001, 2002 and the first nine months 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 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 and abroad against American interests or citizens, U.S. retaliation for these attacks, threats of additional terrorist activity and the war in Iraq have 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, affect the availability of materials needed to manufacture our products, or affect 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 the nine months ended September 30, 2003, SPT serviced end customer shipments accounted for 29.7%, 57.4% and 63.7% 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 International Semiconductor Corporation, or Vanguard, in Taiwan will manufacture the majority of our products for the remainder of 2003. On March 6, 2001, we invested \$50.0 million in GSMC, a Cayman Islands company, for a wafer foundry project located in Shanghai, China. GSMC began manufacturing some of our products early in the fourth quarter 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

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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 plus additional future capacity from GSMC, Shanghai Hua Hong NEC Electronic Company Limited, or HHNEC, and Vanguard available to us will be sufficient through 2004. 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 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 thousand 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 have, from time to time, 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. Either one 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,

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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 and introduce new products.

The markets for our products are characterized by:

- rapidly changing technologies;
- evolving and competing industry standards;
- changing customer needs;
- frequent new product introductions and enhancements;
- increased integration with other functions; and
- rapid product obsolescence.

To develop new products for our target markets, we must develop, gain access to and use leading technologies in a cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we must have our products designed into our customers' future products and maintain close working relationships with key

customers in order to develop new products that meet their changing needs.

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In addition, products for communications applications are based on continually evolving industry standards. Our ability to compete will depend on our ability to identify and ensure compliance with these industry standards. As a result, we could be required to invest significant time and effort and incur significant expense to redesign our products and ensure compliance with relevant standards. We believe that products for these applications will encounter intense competition and be highly price sensitive. While we are currently developing and introducing new products for these applications, we cannot assure you that these products will reach the market on time, will satisfactorily address customer needs, will be sold in high volume, or will be sold at profitable margins.

We cannot assure you that we will be able to identify new product opportunities successfully, develop and bring to market new products, achieve design wins or respond effectively to new technological changes or product announcements by our competitors. In addition, we may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Failure in any of these areas could harm our operating results.

Our future success depends in part on the continued service of our key design engineering, sales, marketing and executive personnel and our ability to identify, recruit and retain additional personnel.

We are highly dependent on Bing Yeh, our President and Chief Executive Officer, as well as the other principal members of our management team and engineering staff. There is intense competition for qualified personnel in the semiconductor industry, in particular the highly skilled design, applications and test engineers involved in the development of flash memory technology. Competition is especially intense in Silicon Valley, where our corporate headquarters is located. We may not be able to continue to attract and retain engineers or other qualified personnel necessary for the development of our business or to replace engineers or other qualified personnel who may leave our employ in the future. Our anticipated growth is expected to place increased demands on our resources and will likely require the addition of new management and engineering personnel and the development of additional expertise by our existing management personnel. The failure to recruit and retain key design engineers or other technical and management personnel could harm our business.

Our ability to compete successfully depends, in part, on our ability to protect our intellectual property rights.

We rely on a combination of patent, trade secrets, copyrights, mask work rights, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Policing unauthorized use of our products, however, is difficult, especially in foreign countries. Litigation may continue to be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition regardless of the outcome of the litigation. We own 75 patents in the United States relating to our products and processes, with expiration dates ranging from 2008 to 2023, and have filed for several more. In addition, we hold several patents in Europe and Canada, and have filed several foreign patent applications in Europe, Japan, Korea, Taiwan and Canada. We cannot assure you that any pending patent application will be granted. Our operating results could be harmed by the failure to protect our intellectual property.



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 material impact on our business and be forced to pay damages.

Third parties may assert that our products infringe their proprietary rights, or may assert claims for indemnification resulting from infringement claims against us. Any such claims may cause us to delay or cancel shipment of our products or pay damages that could harm our business, financial condition and results of operations. In addition, irrespective of the validity or the successful assertion of such claims, we could incur significant costs in defending against such claims.

In the past we were sued both by Atmel Corporation and Intel Corporation regarding patent infringement issues and sued Winbond Electronics Corporation regarding our contractual relationship with them. Significant management time and financial resources have been devoted to defending these lawsuits. We settled with Intel in May 1999, with Winbond in October 2000, and the Atmel litigation is ongoing.

In addition to the Atmel, Intel and Winbond actions, we receive from time to time, letters or communications from other companies stating that such companies have patent rights that involve our products. Since the design of all of our products is based on SuperFlash technology, any legal finding that the use of our SuperFlash technology infringes the patent of another

company would have a significantly negative effect on our entire product line and operating results. Furthermore, if such a finding were made, there can be no assurance that we could license the other company's technology on commercially reasonable terms or that we could successfully operate without such technology. Moreover, if we are found to infringe, we could be required to pay damages to the owner of the protected technology and could be prohibited from making, using, selling, or importing into the United States any products that infringe the protected technology. In addition, the management attention consumed by and legal cost associated with any litigation could harm our operating results.

Public announcements may hurt our stock price.

During the course of lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could harm the market price of our stock.

Our litigation may be expensive, may be protracted and confidential information may be compromised.

Whether or not we are successful in our lawsuit with Atmel, we expect this litigation to continue to consume substantial amounts of our financial and managerial resources. On April 8, 2002, a jury found that we willfully infringed Atmel's '811 and '829 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 September 12, 2003 the Federal Circuit issued a decision upholding the trial court verdict. We

believe that the Federal Circuit's decision was erroneous and inconsistent with its precedent, and on September 25, 2003 we petitioned the Court to reconsider its decision. The Court asked Atmel to respond to our petition, and Atmel filed its Opposition on October 21, 2003. The Court may affirm or reverse its decision without further input from the parties, or it may ask for further briefing or argument from the parties. 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 the third quarter of 2003, we recorded a \$36.5 million liability based on the Atmel judgement due to the increased probability of a loss in the litigation. In addition, we have incurred certain costs associated with defending this matter, and at any time Atmel may file additional claims against us, which could increase the risk, expense and duration of the litigation. Further, because of the substantial amount of discovery required in connection with this type of litigation, there is a risk that some of our confidential information could be compromised by disclosure. For more information with respect to our litigation, please also see "Part II, Item 1 - Legal Proceedings."

If an earthquake or other natural disaster strikes our manufacturing facility or those of our suppliers, we would be unable to manufacture our products for a substantial amount of time and we would experience lost revenues.

Our corporate headquarters are located in California near major earthquake faults. In addition, some of our suppliers are located near fault lines. In the event of a major earthquake or other natural disaster near our headquarters, our operations could be harmed. Similarly, a major earthquake or other natural disaster such as typhoon near one or more of our major suppliers, like the earthquake in September 1999 or the typhoon in September 2001 that occurred in Taiwan could potentially disrupt the operations of those suppliers, which could then limit the supply of our products and harm our business.

A virus or viral outbreak in Asia could harm our business.

We derive substantially all of our revenues from Asia and our logistics center is located in Taiwan. A virus or viral outbreak in Asia, such as the recent SARS outbreak in early 2003, could harm the operations of our suppliers, distributors, logistics center and those of our end customers, which could then harm our business.

Prolonged electrical power outages, energy shortages, or increased costs of energy could harm our business.

Our design and process research and development facilities and our corporate offices are located in California, which is susceptible to power outages and shortages as well as increased energy costs. To limit this exposure, all corporate computer systems at our main California facilities are on battery back-up. In addition, all of our engineering and back-up servers and selected corporate servers are on generator back-up. While the majority of our production facilities are not located in California, more extensive power shortages in the state could delay our design and process research and development as well as increase our operating costs.

Our growth has in the past placed a significant strain on our management systems and resources and if we fail to manage our growth, our ability to market or sell our products or to develop new products may be harmed.

Our business has in the past experienced rapid growth which strained our internal systems and future growth will require us to

continuously develop sophisticated information management systems in order to manage our business effectively. We are currently implementing a supply-chain management system and a vendor electronic data interface system. There is no guarantee that we will be able to implement these new systems in a timely fashion, that in themselves they will be adequate to address any growth or that we will be able to foresee in a timely manner other infrastructure needs before they arise. Our success depends on the ability of our executive officers to effectively manage our growth. If we are unable to manage our growth effectively, our results of operations will be harmed. If we fail to successfully implement new management information systems, our business may suffer severe inefficiencies that may harm the results of our operations.

#### Risks Related to Our Industry

Our success is dependent on the growth and strength of the flash memory market.

All of our products, as well as all new products currently under design, are stand-alone flash memory devices or devices embedded with flash memory. A memory technology other than SuperFlash may be adopted as an industry standard. Our competitors are generally in a better financial and marketing position than we are from which to influence industry acceptance of a particular memory technology. In particular, a primary source of competition may come from alternative technologies such as FRAM devices if such technology is commercialized for higher density applications. To the extent our competitors are able to promote a technology other than SuperFlash as an industry standard, our business will be seriously harmed.

The selling prices for our products are extremely volatile and have historically declined during periods of over capacity or industry downturns.

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 average selling prices. In some cases, downturns, such as the one we have experienced since late 2000, have lasted for more than a year. Our business could be harmed by industry-wide fluctuations in the future. The flash memory products portion of the semiconductor industry, from which we derive substantially all of our revenues suffered from excess capacity in 1996, 1997 and 1998, which resulted in greater than normal declines in our markets, which unfavorably impacted our revenues, gross margins and profitability. While these conditions improved in 1999 and 2000 and began to improve during the third quarter of 2003, deteriorating market conditions at the end of 2000 and continuing through the first nine months of 2003 have resulted in the decline of our selling prices and harmed our operating results.

There is seasonality in our business and if we fail to continue to introduce new products this seasonality may become more pronounced.

Sales of our products in the consumer electronics applications market are subject to seasonality. As a result, sales of these products are impacted by seasonal purchasing patterns with higher sales generally occurring in the second half of each year. In the past we have been able to mitigate such seasonality with the introduction of new products throughout the year. If we fail to continue to introduce new products, our business may suffer and the seasonality of a portion of our sales may become more pronounced.

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufacturing and sales activities. These exposures may change over time as business practices evolve and could negatively impact our operating results and financial condition. All of our sales are denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore reduce the demand for our products. Such a decline in the demand could reduce revenues and/or result in operating losses. In addition, a downturn in the economies of China, Japan or Taiwan could impair the value of our equity investments in companies with operations in these countries. If we consider the value of these companies to be impaired, we will write down, or expense, some or all of our investments. In the fourth quarter of 2001, we wrote down our investment in KYE by \$3.3 million to \$1.3 million due to an other than temporary decline in its market value. As of September 30, 2003, the recorded value of our KYE investment was \$2.2 million based on the quoted market price as of the balance sheet date. In the third quarter of 2002, we wrote down our investment in Apacer, a privately held memory module manufacturer located in Taiwan, by \$7.8 million due to an other than temporary decline in its value. As of September 30, 2003, the recorded value of our Apacer investment was \$4.4 million. We have

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marketable security investments in Taiwan with recorded values of \$17.9 million as of September 30, 2003. We also have equity investments in companies with operations in China, Japan, Taiwan and United States with recorded values as of September 30, 2003 of \$50.0 million, \$939 thousand, \$4.4 million and \$333 thousand, respectively.

At any time, fluctuations in interest rates could affect interest earnings on our cash, cash equivalents and available-for-sale investments, or the fair value of our investment portfolio. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. As of September 30, 2003, the carrying value of our available-for-sale investments approximated fair value. The table below presents the carrying value and related weighted average interest rates for our unrestricted and restricted cash, cash equivalents and available-for-sale investments as of September 30, 2003 (in thousands):

	Carrying Value	Interest Rate
	-----	-----
Cash and cash equivalents - variable rate.....	\$ 147,920	0.5%
Short-term available-for-sale investments - fixed rate.....	51,956	1.2%
Long-term available-for-sale investments (1 to 2 years) - fixed rate.....	16,425	1.3%
	-----	
	\$ 216,301	0.7%
	=====	

Item 4. Controls and Procedures

Based on their evaluation as of September 30, 2003, our chief executive officer and chief financial officer, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were sufficiently effective to ensure that the information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and Form 10-Q. There were no changes in our internal control over financial reporting during the quarter ended September 30, 2003 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## PART II

### Item 1. Legal Proceedings

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. 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 infringed 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 issued a Limited Exclusion Order, which 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. 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. We intervened as a party in the Macronix case for purposes of opposing that motion. 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 September 12, 2003 the Federal Circuit issued a decision upholding the trial court verdict. We believe that the Federal Circuit's decision was erroneous and inconsistent with its precedent, and on September 25, 2003 we petitioned the Court to reconsider its decision. The Court asked Atmel to respond to our petition, and Atmel filed its Opposition on October 21, 2003. The Court may affirm or reverse its decision without further input from the parties, or it may ask for further briefing or argument from the parties. 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 September 30, 2003, this amount is included in restricted cash, cash equivalents and available-for-sale investments in our balance sheet.

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 appeal of the verdict regarding the '811 and '829 patents is finally 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. In the third quarter of 2003, we recorded a \$36.5 million liability due to an increased probability of a loss in the Atmel litigation, based on the most recent judgement in this litigation. As for other legal actions that may arise in the ordinary course of business, 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 other than the losses related to Atmel have been accrued in our financial statements as of September 30, 2003.

## Item 6. Exhibits and Reports on Form 8-K

### (a) *Exhibits.*

We incorporate by reference all exhibits filed in connection with our annual report on Form 10-K for the year ended December 31, 2002.

Exhibit 31.1 Certification required by Rule 13a-14(a).

Exhibit 31.2 Certification required by Rule 13a-4(a).

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Exhibit 32.1 Certification of President and Chief Executive Officer, as required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).\*

Exhibit 32.2 Certification of Vice President Finance & Administration, Chief Financial Officer and Secretary, as required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).\*

\* The certifications attached as Exhibit 32.1 and Exhibit 32.2 accompany the Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

(b) Reports on Form 8-K filed during the quarter ended September 30, 2003: On July 23, 2003, we filed a current report on Form 8-K in connection with the issuance of a press release dated July 23, 2003 announcing our financial results for the second quarter of 2003. The press release was furnished under Item 9. On September 19, 2003, we filed a current report on Form 8-K in connection with the issuance of a press release dated September 18, 2003 announcing "SST Comments on Court Decision in Lawsuit With Atmel." The press release was furnished under Item 5.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, County of Santa Clara, State of California, on the 13th day of November, 2003.

SILICON STORAGE TECHNOLOGY, INC.

By:

/s/ BING YEH

Bing Yeh

*President and Chief Executive Officer*

*(Principal Executive Officer)*

/s/ JEFFREY L. GARON

Jeffrey L. Garon

*Vice President Finance & Administration,*

*Chief Financial Officer and Secretary*

*(Principal Financial and Accounting Officer)*



