

DESWELL INDUSTRIES INC

Form 20-F

July 29, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 20-F**

(Mark one)

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**For the fiscal year ended March 31, 2010**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_ ;**

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

**Date of event requiring this shell company report**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-33900  
DESWELL INDUSTRIES, INC.**

British Virgin Islands

(Jurisdiction of incorporation or organization)

17B, Edificio Comercial Rodrigues,  
599 Avenida da Praia Grande, Macao  
Special Administrative Region, PRC  
(Address of Principal Executive Offices)

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Special Administrative Region, PRC  
(Name, Telephone, E-mail and/or Facsimile number and  
Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act: Common shares, no par value

Securities registered pursuant to Section 12(g) of the Act: NONE

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: NONE As of March 31, 2010, there were 16,191,810 common shares of the registrant outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  Yes  No

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant: (i) 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

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required to file such reports), and (ii) has been subject to such filing requirements for the past 90 days.  Yes  No  
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes<sup>(1)</sup>  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

If Other has been checked, indicate by check mark which financial statement item the registrant has elected to follow:  
 Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

(1) Interactive data filing is not required of registrant until its Annual Report on Form 20-F for the year ending March 31, 2012

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Certification Of Chief Executive Officer Required By Rule 13a-14(A) Or Rule 15d-14(A) Under  
The Securities Exchange Act Of 1934

Exhibit 12.1

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Certification Of Chief Financial Officer Required By Rule 13a-14(A) Or Rule 15d-14(A) Under  
The Securities Exchange Act Of 1934

Exhibit 12.2

Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 Of The  
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**INTRODUCTION**

This Annual Report on Form 20-F contains forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to those discussed in the section entitled Risk Factors under Item 3. Key Information.

Readers should not place undue reliance on forward-looking statements, which reflect management's view only as of the date of this Report. The Company undertakes no obligation to revise these forward-looking statements to reflect subsequent events or circumstances. Readers should also carefully review the risk factors described in other documents the Company files from time to time with the Securities and Exchange Commission.

Except where the context otherwise requires and for purposes of this Annual Report only:

we, us, our company, our, the Company or Deswell refers to Deswell Industries, Inc. and, in the context describing our operations, also include our operating subsidiaries;

shares refer to our common shares, no par value;

China or PRC refers to the People's Republic of China, excluding Taiwan, Hong Kong and Macao;

Hong Kong refers to the Hong Kong Special Administrative Region of the People's Republic of China;

Macao refers to the Macao Special Administrative Region of the People's Republic of China;

all references to renminbi, RMB or yuan are to the legal currency of China, of which the yuan is the base unit;

all references to HK dollars or HK\$ are to the legal currency of Hong Kong; and

all references to U.S. dollars, dollars, \$ or US\$ are to the legal currency of the United States.

**FINANCIAL STATEMENTS AND CURRENCY PRESENTATION**

The Company prepares its consolidated financial statements in accordance with generally accepted accounting principles in the United States of America and publishes such statements in United States dollars. See Report of Independent Registered Public Accounting Firm included elsewhere herein. The Company publishes its financial statements in United States dollars as the Company is incorporated in the British Virgin Islands, where the currency is the U.S. dollar. Moreover, the functional currency of the Company's subsidiaries has been changed from the Hong Kong dollar or Chinese RMB to the US dollar since January 1, 2009.

**PART I**

**Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

Not applicable.

**Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**Item 3. KEY INFORMATION**

The selected consolidated financial data set forth below should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Report. The selected income statement data for each of the three fiscal years in the period ended March 31, 2010, and the balance sheet data as of March 31, 2009 and 2010 are derived from our audited consolidated financial statements included in this Report. The selected income statement data for the years ended March 31, 2006 and 2007, and the balance sheet data as of March 31, 2006, 2007 and 2008 are derived from our audited consolidated financial statements, which are not included in this Report.

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(in thousands except per share and statistical data)

|   | Year ended March 31, |            |            |            |           |
|---|----------------------|------------|------------|------------|-----------|
|   | 2006                 | 2007       | 2008       | 2009       | 2010      |
| <b>Income Statement Data:</b>                               |                      |            |            |            |           |
| Net sales   | \$ 115,276           | \$ 136,779 | \$ 143,806 | \$ 131,738 | \$ 81,614 |
| Cost of sales   | 89,850               | 105,506    | 117,373    | 111,570    | 68,958    |
| Gross profit  | 25,426               | 31,273     | 26,433     | 20,168     | 12,656    |
| Selling, general and administrative expenses                | 15,052               | 18,957     | 19,601     | 19,291     | 15,505    |
| Other income (expenses), net                                | (823)                | 1,376      | 1,838      | (132)      | 4,594     |
| Operating income <sup>(2)</sup>                             | 9,551                | 13,692     | 8,670      | 745        | 1,745     |
| Interest expense <sup>(6)</sup>                             | 447                  | 547        | 521        | 168        | 444       |
| Non-operating income, net                                   |                      |            |            |            |           |
| Income before income taxes                                  | 9,992                | 14,239     | 9,191      | 913        | 2,189     |
| Income taxes  | (27)                 | 1,239      | 104        | (282)      | 690       |
| Net income  | 10,019               | 13,000     | 9,087      | 1,195      | 1,499     |
| Net income attributable to non-controlling interests        | 1,240                | 833        | 228        |            |           |
| Net income attributable to Deswell Industries, Inc.         | \$ 8,779             | \$ 12,167  | \$ 8,859   | \$ 1,195   | \$ 1,499  |
| Basic earnings per share <sup>(3)</sup>                     | \$ 0.59              | \$ 0.81    | \$ 0.57    | \$ 0.08    | \$ 0.09   |
| Average number of shares outstanding basic <sup>(3)</sup>   | 14,908               | 14,956     | 15,517     | 15,791     | 15,965    |
| Diluted earnings per share <sup>(3)</sup>                   | \$ 0.59              | \$ 0.81    | \$ 0.57    | \$ 0.08    | \$ 0.09   |
| Average number of shares outstanding diluted <sup>(3)</sup> | 14,936               | 15,048     | 15,566     | 15,805     | 16,039    |
| <b>Statistical Data:</b>                                    |                      |            |            |            |           |
| Gross margin  | 22.1%                | 22.9%      | 18.4%      | 15.3%      | 15.5%     |
| Operating margin <sup>(2)</sup>                             | 8.3%                 | 10.0%      | 6.0%       | 0.6%       | 2.1%      |
| Dividends per share   | \$ 0.63              | \$ 0.65    | \$ 0.61    | \$ 0.24    | \$ 0.10   |

|                                      | At March 31, |           |           |           |           |
|--------------------------------------|--------------|-----------|-----------|-----------|-----------|
|                                      | 2006         | 2007      | 2008      | 2009      | 2010      |
| <b>Balance Sheet Data:</b>           |              |           |           |           |           |
| Working capital                      | \$ 55,114    | \$ 58,672 | \$ 54,751 | \$ 52,605 | \$ 59,848 |
| Total assets                         | 130,670      | 141,210   | 140,407   | 137,482   | 134,011   |
| Long-term debt, less current portion |              |           |           |           |           |
| Total debt                           |              |           |           |           |           |
| Shareholders' equity                 | 106,768      | 111,655   | 121,257   | 120,307   | 121,015   |

- (1) Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States of America and are stated in U.S. dollars. See Financial Statements and Currency Presentation.
- (2) Other operating income was reclassified in the consolidated statement of income for the year ended March 31, 2007 for a comparable presentation. Comparative figures for the years ended March 31, 2006 were reclassified accordingly. The reclassification of operating income had no impact on the net income on the consolidated statements of income for the year ended March 31, 2006.
- (3) Basic EPS excludes dilution from potential common shares and is computed by dividing income available



to common  
shareholders by  
the  
weighted-average  
number of  
common shares  
outstanding for  
the period.  
Diluted EPS  
reflects the  
potential dilution  
from potential  
common shares.

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### **Risk Factors**

We may from time to time make written or oral forward-looking statements. Written forward-looking statements may appear in this document and other documents filed with the Securities and Exchange Commission, in press releases, in reports to shareholders, on our website, and other documents. The Private Securities Reform Act of 1995 contains a safe harbor for forward-looking statements on which we rely in making such disclosures. In connection with this safe harbor, we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Any such statement is qualified by reference to the following cautionary statements:

**We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us. These risks have become particularly acute in the current adverse economic environment.**

Historically, a substantial percentage of our sales have been to a small number of customers. Customers that individually accounted for ten percent or more of our net sales during the years ended March 31, 2008, 2009 and 2010, accounted for 53.3%, 41.3% and 42.0%, respectively, of our total net sales during those years. Our three largest customers during the year ended March 31, 2010 were N&J Company Limited, Digidesign, Inc. and VTech Telecommunications Limited. Each of these customers individually accounted for 10% or more of our total net sales during the year ended March 31, 2010.

Our sales are based on purchase orders and we have no long-term contracts with any of our customers and the percentage of sales to any of our customers may fluctuate from time to time. Economic conditions prevailing since 2008 have had a negative impact on our results of operations during fiscal 2009 and 2010 are expected to continue to have a negative impact on our operations over the next several quarters and possibly beyond. We cannot assure you that present or future customers will not cease using us as the source of the injection-molded plastic parts and components we manufacture, for electronic manufacturing services of electrical products and subassemblies or for metallic molds and accessories or significantly change, reduce or delay the amount of products and services ordered from us. Substantial decreases in sales from any of our larger customers, or the loss of any major customers, would adversely impact our sales and financial performance. For example, N&J Company Ltd., our largest customer in both fiscal 2009 and 2010, reduced the volume of its orders during the year ended March 31, 2010 to 19.2% of our total sales from 28.6% of our total sales in fiscal 2009. Similarly, Digidesign, Inc., our largest customer in fiscal 2008, reduced the volume of its orders during the year ended March 31, 2009 to 12.7% of our total sales from 17.0% of our total sales in fiscal 2008. These reductions in sales to our major customers contributed to the decreases in our total sales in fiscal 2009 from fiscal 2008 and in fiscal 2010 from fiscal 2009.

**The global economic weakness has adversely affected our earnings, liquidity and financial condition and, until global economic conditions improve, is expected to continue to do so.**

Global financial and credit markets have been, and continue to be, extremely unstable and unpredictable. Worldwide economic conditions have been weak and may be further deteriorating. The instability of the markets and the continuing global economic weakness negatively impacted our operating results and could continue to affect adversely

the demand for our customers' products,

the amount, timing and stability of their orders to us,

the financial strength of our customers and suppliers,

their ability or willingness to do business with us,

our willingness to do business with them,

our suppliers' and customers' ability to fulfill their obligations to us,

the ability of our customers, our suppliers or us to obtain credit, secure funds or raise capital, and the prices at which we can sell our products and services.

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In the prevailing uncertain economic environment, we cannot predict with reasonable accuracy future levels of demand for our customers' electronics products and therefore cannot predict with reasonable accuracy the future level of demand for our services in manufacturing them. If prevailing economic conditions continue to persist or worsen, our ability to manage inventory levels effectively and collect our receivables could be impaired, our need for cash could increase, and our net revenue, gross margins or results of operations could continue to suffer.

**Our exposure to financially troubled customers or suppliers may adversely affect our financial results.**

We manufacture and sell injection-molded plastic parts and components and provide manufacturing services for electrical products and subassemblies to companies and industries that have in the past, and may in the future, experience financial difficulty, particularly in light of conditions in the credit markets and the overall worldwide economy. Our suppliers may also experience financial difficulty in this environment. If our customers experience financial difficulty, we could have difficulty recovering amounts owed to us from these customers, or demand for our products and services from these customers could decline. Additionally, if our suppliers experience financial difficulty we could have difficulty sourcing supply necessary to fulfill production requirements and meet scheduled shipments. The current global financial crisis is continuing to adversely affect our customers' and suppliers' access to capital and liquidity. If one or more of our customers were to become insolvent or otherwise were unable to pay for the products or services provided by us on a timely basis, or at all, our operating results and financial condition could be adversely affected. Such adverse effects could include one or more of the following: a provision for doubtful accounts, a charge for inventory write-offs, a reduction in revenue, and increases in working capital requirements due to increases in days in inventory and increases in days in accounts receivable.

**Our gross margins fluctuate from year to year and may be adversely affected by a number of factors.**

The following chart shows, for the years indicated, our gross margins from our two principal operating segments and for our company as a whole:

**Gross Margins Percentage**

We expect gross margins generally and for specific products to continue to fluctuate from year to year. Fluctuations in our margins have been affected, often adversely, and may continue to be affected, by numerous factors, including:

increasing competition in our market segments, which has forced us to maintain or reduce unit prices or attempt to pass on our costs of materials and components on to customers;

our cost of raw materials, especially our cost of plastic resins;

costs of labor, particularly in recent years, which such costs have increased substantially as consequence of increasing governmental regulation directed at labor practices and policies;

changes in the prices or the availability of components needed to manufacture our electronic products;

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changes in our customer mix or the mix of higher and lower margin products, or a combination of both in any year;

increases in value-added taxes as result of changes in the value-added tax policy of the Chinese government for various categories of export products; and

increased costs of conforming our products to consumer and product safety laws and regulations of the various countries in which our products are sold.

In the five years prior to our year ended March 31, 2010, the appreciation of the exchange rate of the RMB, in which we pay our labor and manufacturing costs, against the U.S. dollar, in which we present our financial statements was a factor that contributed to decreases in our gross margins. In fiscal 2010, however, the RMB to US dollar exchange rate was relatively stable. See the Risk Factor entitled "Changes in currency exchange rates have and could continue to significantly affect our financial results," below. Because of that stability, together with our implementation of vigorous cost controls, we were able to maintain our aggregate gross margins at the same level as in fiscal 2009 despite continuing adverse global economic conditions that caused our fiscal 2010 sales to decrease substantially from sales during fiscal 2009. However, our gross margins may continue to decline if global market conditions continue to affect our sales volume adversely, if our sales otherwise decrease, if the exchange rate of the RMB resumes materially appreciating to the US dollar or as consequence of other factors, including one or more of those listed above. If we cannot stem the decline in our gross margins, our operating results would suffer, dividend payments to shareholders may be decreased or eliminated, our financial position may be harmed and our stock price may fall.

**If OEMs stop or reduce their manufacturing outsourcing, our business could suffer.**

Our revenues depend on outsourcing by OEMs to us and to other contract manufactures for which we manufacture end-products or parts and components. Current and prospective customers continuously evaluate our capabilities against other providers as well as against the merits of manufacturing products themselves. Our business would be adversely affected if OEMs decide to perform these functions internally. Similarly, we depend on new outsourcing opportunities to militate against lost revenues arising from the decline in demand for our customers' products as a consequence of the current global economic slowdown, and our business would be adversely affected if we are not successful in gaining additional business from these opportunities or if OEMs do not outsource additional manufacturing business.

**Our industry is extremely competitive, with aggressive pricing dynamics, and; if we are not able to continue to provide competitive products and services, we may lose business.**

We compete with a number of different companies in producing of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. For example, we compete with Asian-based suppliers of injection-molded plastic parts and components, major global electronic manufacturing services, or EMS, providers, other smaller EMS companies that have a regional or product-specific focus, and original design manufacturers with respect to some of the services that we provide. We also compete with our current and prospective customers, who evaluate our capabilities in light of their own capabilities and cost structures. Our market segments are extremely competitive, many of our competitors have achieved substantial market share and many have lower cost structures and greater manufacturing, financial or other resources than we do. We face particular competition from Asian-based competitors, including Taiwanese EMS providers which compete in our end markets. If we are unable to provide comparable manufacturing services and improved products at lower cost than the other companies in our market, our net sales could decline.

The current global economic crisis may also increase the competitive environment in our market segments which could also impact our operating results. In addition, the EMS industry is currently experiencing excess manufacturing capacity and has seen increased competition. These factors have exerted and will continue to exert additional pressures on pricing for injection-molded plastic parts and components and for our electronic manufacturing services, thereby increasing the competitive pressures in our market segments generally. We may not be able to compete successfully against our current and future competitors, and the competitive pressures we face may have a material adverse effect on us.



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**We have no long-term contracts to obtain plastic resins and our profit margins and net income could suffer from an increase in resin prices.**

The primary materials used by us in the manufacture of our plastic injection molded products are various plastic resins. The following table shows our cost of plastic resins as a percentage of our cost of plastic products sold and as a percentage of our total costs of goods sold for the years ended March 31, 2008, 2009 and 2010:

We have no long-term contracts with our resin suppliers. Accordingly, our financial performance is dependent to a significant extent on resin markets and the ability to pass through price increases to our customers. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are subject to cyclical price fluctuations, including those arising from supply shortages. Consequently, resin prices may fluctuate as a result of changes in natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced. We have found that increases in resin prices are difficult to pass on to our customers. In the past, increases in resin prices have increased our costs of goods sold and adversely affected our profit margins. A significant increase in resin prices in the future could likewise adversely affect our profit margins and results of operations.

**We have no written agreements with suppliers to obtain components and our profit margins and net income could suffer from an increase in component prices and our results of operations could suffer from shortages of required electronic components.**

We have no written agreements with our component suppliers and for certain customers, we are responsible for purchasing components used in manufacturing their products. This could result in our bearing the risk of component price increases because we may be unable to procure the required materials at a price level necessary to generate anticipated margins. Accordingly, our financial performance could be materially or adversely affected by any increase in component prices.

From time to time, we have experienced shortages of some of the electronic components that we need and use in our electronics manufacturing market segment. These shortages can result from strong demand for those components or from problems experienced by suppliers. These unanticipated component shortages could result in curtailed production or delays in production, which may prevent us from making scheduled shipments to customers. Our inability to make scheduled shipments could cause us to experience a reduction in sales, increase in inventory levels and costs, and could adversely affect relationships with existing and prospective customers. Component shortages may also increase our cost of goods sold because we may be required to pay higher prices for components in short supply and redesign or reconfigure products to accommodate substitute components. As a result, component shortages could adversely affect our operating results. Our performance depends, in part, on our ability to incorporate changes in component costs into the selling prices for our products.

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**The Chinese government could change its policies toward or even nationalize private enterprise, which could result in the total loss of our investment in that country.**

Our manufacturing facilities are located in China. As a result, our operations and assets are subject to significant political, economic, legal and other uncertainties associated with doing business in China. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time without notice. Changes in policies by the Chinese government resulting in changes in laws, regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion or imports and sources of supply could materially and adversely affect us. The nationalization or other expropriation of private enterprises by the Chinese government could result in the total loss of our investment in that country.

**There may be a lack of remedies and impartiality under the Chinese legal system that prevents us from enforcing the agreements under which we operate our factories.**

We do not own the land on which our factories in China are located. We occupy our manufacturing facilities under land use agreements or under tenancy agreements with the local Chinese government. These agreements may be difficult to enforce in China, which could force us to accept terms that may not be as favorable as those provided in our agreements. Unlike the U.S., China has a civil law system based on written statutes in which judicial decisions have little precedential value. The Chinese government has enacted some laws and regulations dealing with matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, their experience in implementing, interpreting and enforcing these laws and regulations is limited, and our ability to enforce commercial claims or to resolve commercial disputes is unpredictable. These matters may be subject to the exercise of considerable discretion by agencies of the Chinese government, and forces unrelated to the legal merits of a particular matter or dispute may influence their determination.

**If our business licenses in China were not renewed, we would be required to move our operations out of China, which would impair our profitability, competitiveness and market position and jeopardize our ability to continue operations.**

Our activities in China require business licenses, the scope of which is limited to our present activities, and require review and approval of our activities by various national and local agencies of Chinese government. The Chinese government may not continue to approve our activities, grant or renew our licenses or grant or renew licenses to expand our existing activities. Our inability to obtain needed approvals or licenses could prevent us from continuing to conduct operations in China. If for any reason we were required to move our manufacturing operations outside of China, our profitability would be substantially impaired, our competitiveness and market position would be materially jeopardized and we may not be able to continue operations.

**Our insurance coverage may not be adequate to cover losses related to major accidents, forces of nature or product liability risks.**

Firefighting and disaster relief or assistance in China are primitive by Western standards. At March 31, 2010, we maintained fire, casualty and theft insurance aggregating approximately \$103 million covering certain of our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. The proceeds of this insurance may not be sufficient to cover material damage to, or the loss of, any of our factories due to fire, severe weather, flood, forces of nature or other causes, such as the 2008 earthquake that devastated areas in Sichuan province in China and the 2010 earthquake that killed and injured over 14,000 people and damaged many buildings in Yushu County in China's Southern Qinghai province. The epicenters of those earthquakes were about 850 and 1,450 miles, respectively, from our factories in Dongguan, China. We do not maintain any business interruption insurance or earthquake insurance.

Despite quality assurance measures, there remains a risk that defects may occur in our products. The occurrence of any defects in our products could give rise to liability for damages caused by such defects. They could, moreover, impair the market's acceptance of our products. At March 31, 2010, we had only limited product liability insurance. Although we have not experienced any product quality claims from our major customers, if future claims do arise, costs to defend, adverse judgments or amounts we may be forced to pay in settlement would increase our expenses.



Damages to our reputation resulting from such claim(s) could cause our customers to use other vendors which would hurt our revenues.

**Table of Contents****Payment of dividends by our subsidiaries in the PRC to us is subject to restrictions under PRC law. The new PRC tax law could force us to reduce the amount of dividends we have historically paid to our shareholders or possibly eliminate them or we may decide not pay dividends in the future.**

Under PRC law, dividends may be paid only out of distributable profits. Distributable profits with respect to our subsidiaries in the PRC refers to after-tax profits as determined in accordance with accounting principles and financial regulations applicable to PRC enterprises ( China GAAP ) less any recovery of accumulated losses and allocations to statutory funds that it is required to make. Any distributable profits that are not distributed in a given year are retained and available for distribution in subsequent years. The calculation of distributable profits under China GAAP differs in many respects from the calculation under U.S. GAAP. As a result, our subsidiaries in PRC may not be able to pay any dividend in a given year as determined under U.S. GAAP. The China s tax authorities may require changes in determining income of the Company that would limit its ability to pay dividends and make other distributions. PRC law requires companies, including our PRC subsidiaries, to reserve about 10% of their profits for future development and staff welfare, which amounts are not distributable as dividends. These rules and possible changes to them could restrict our PRC subsidiaries from repatriating funds ultimately to us and our stockholders as dividends.

Prior to the new unified enterprise income tax ( EIT ) law which became effective in China on January 1, 2008, PRC-organized companies were exempt from withholding taxes with respect to earnings distributions, or dividends, paid to shareholders of PRC companies outside the PRC, such as was the case when our PRC subsidiaries distributed portions of their earnings to our offshore subsidiaries. However, under the new EIT Law, dividends payable to foreign investors which are derived from sources within the PRC are subject to income tax at the rate of 10% by way of withholding unless the foreign investors are companies incorporated in countries which have a tax treaty agreement with PRC and rate agreed by both parties will be applied. As a result of this new PRC withholding tax, amounts available to us in earnings distributions from our PRC enterprises have been reduced. Since we derive most of our profits from our subsidiaries in the PRC, the reduction in amounts available for distribution from our PRC enterprises could, depending on the income generated by our PRC subsidiaries, force us to reduce, or possibly eliminate, the dividends we have paid to our shareholders historically. For this reason, or other factors, we may decide not to declare dividends in the future. If we do pay dividends, we will determine the amounts when they are declared and even if we do declare dividends in the future, we may not continue them in any future period.

**Under the China s EIT Law, we may be classified as a resident enterprise for PRC tax purposes, which may subject us to PRC enterprise income tax for any dividends we receive from our Chinese subsidiaries and to PRC income tax withholding for any dividends we pay to our non-PRC stockholders.**

Under the PRC s new EIT Law, an enterprise established outside of China whose de facto management bodies are located in China is considered a resident enterprise and is subject to the 25% enterprise income tax rate on its worldwide income. The new EIT Law and its implementing rules are relatively new, and currently, no official interpretation or application of this new resident enterprise classification is available. Therefore, it is unclear how tax authorities will determine the tax residency of enterprises established outside of China.

All of our manufacturing operations are conducted and managed in the PRC. Our corporate structure, illustrating our incorporation in British Virgin Islands and our ownership of companies inside and outside of China, is set forth on page 19 of this Report. If the PRC tax authorities determine that our holding company structure utilizing companies outside of China is a resident enterprise for PRC enterprise income tax purposes, we may be subject to an enterprise income tax rate of 25% on our worldwide taxable income. The resident enterprise classification also could subject us to a 10% withholding tax on any dividends we pay to our non-PRC stockholders if the relevant PRC authorities determine that such income is PRC-sourced income. In addition to the uncertainties regarding the interpretation and application of the new resident enterprise classification, the new EIT Law may change in the future, possibly with retroactive effect. If we are classified as a resident enterprise and we incur these tax liabilities, our net income would decrease accordingly.

**If the United States Internal Revenue Service does not agree with our determination regarding our PFIC status under US income tax laws and seeks to treat us as a PFIC, US holders of our shares could be subject to potentially adverse tax consequences.**

We have not made a precise determination of whether or not we may have become a passive foreign investment company, or PFIC. However, based on the composition of our annual gross income and the book value of our assets and the total market value, or market cap, of our shares at the end of each quarter of our fiscal year

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ended March 31, 2010, we believe that we were not a PFIC for U.S. federal income purposes for our fiscal years ended March 31, 2009 or 2010. No assurance can be given that the IRS may not disagree and seek to treat us as a PFIC, in which case U.S. Holders would be subject to potentially adverse tax consequences, as described under United States Federal Income Tax Consequences Passive Foreign Investment Company (PFIC) in Item 10 Additional Information beginning on page 48 of this Report.

**Controversies affecting China's trade with the United States could harm our operations or depress our stock price.**

While China has been granted permanent most favored nation trade status in the United States, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could adversely affect our business by, among other things, causing our products in the United States to become more expensive, which could result in a reduction in the demand for our products by customers in the United States. Political or trade friction between the United States and China, whether or not actually affecting our business, could also adversely affect the prevailing market price of our common shares. This risk has increased in recent years as our sales into the United States have accounted for significant amounts of our global sales.

**Changes in currency exchange rates have and could continue to significantly affect our financial results.**

Our sales are mainly in United States dollars and Hong Kong dollars and our expenses are mainly in United States dollars, Hong Kong dollars and Chinese RMB.

The Hong Kong dollar has been pegged to the U.S. dollar at approximately 7.80 and relatively stable. The exchange rates between the Hong Kong dollars and the U.S. dollar were approximately 7.782, 7.7597 and 7.764 at March 31, 2008, 2009 and 2010, respectively. The Hong Kong government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar and has not in the past presented a material currency exchange risk. Although announcements by Hong Kong's central bank indicate its intention to maintain the currency peg between the Hong Kong dollar and the U.S. dollar, if Hong Kong does change and follows China to a floating currency system or otherwise changes the exchange rate system of Hong Kong dollars to the U.S. dollars, our margins and financial results could be adversely affected.

Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People's Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11. The following chart illustrates the fluctuations of the RMB to the US dollar from July 21, 2005 by showing, on a calendar and Deswell-fiscal year basis, the exchange ratio at the end of each quarter after July 21, 2005, the date of the RMB to US dollar adjustment to March 31, 2010.

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(1) RMB (yuan) to US dollar data presented in this chart were derived from the historical currency converter available at <http://forex-history.net>.

(2) If the end of a quarter fell on a Saturday or Sunday, datum is provided as of the previous Friday.

Approximately 48.7%, 35.1% and 51.0% of our total costs and expenses were in RMB during the years ended March 31, 2008, 2009 and 2010, respectively.

In our fiscal years following the July 21, 2005 adjustment in the exchange ratio, the exchange ratio of the RMB to the US dollar has appreciated each year through March 31, 2010, albeit to a substantially lesser degree beginning in mid-2008. The following table shows the percentage appreciation.

| <b>Exchange ratio of RMB to US\$1.00 at March 31,</b> |                               |              |                               |              |                               |              |                               |              |                               |
|---|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|
| <b>2006</b>   |                               | <b>2007</b>  |                               | <b>2008</b>  |                               | <b>2009</b>  |                               | <b>2010</b>  |                               |
| <b>Ratio</b>  | <b>% change<sup>(1)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> |
| 1:8.017   | 1.16%                         | 1:7.730      | 3.58%                         | 1:7.012      | 9.29%                         | 1:6.834      | 2.54%                         | 1:6.826      | 0.11%                         |

(1) From ratio at July 22, 2005.

(2) From ratio at preceding March 31.

In mid-2008, the Chinese government halted allowing the RMB to appreciate against the dollar as it did during earlier periods since July 25, 2005 because of concerns that the stronger RMB was hurting Chinese exports at a time of global recession. Accordingly, as shown in the above table, there was virtually no change in the exchange ratio of the RMB to the US dollar during our year ended March 31, 2010. However, on June 19, 2010 China's central bank announced that it planned to introduce more flexibility in the management of its currency and since then the RMB has again begun to appreciate against the US dollar, increasing approximately 0.7% from, according to the historical currency converter available at <http://forex-history.net>, RMB 6.8262 on June 18, 2010 to RMB 6.78 on July 22, 2010.

If the RMB continues its appreciation to the U.S. dollar, our operating costs will increase and the prices of our products in our markets will increase, adversely affecting our financial results unless we pass on such increases to our customers by increasing the prices of our products. If we determined to pass onto our customers through price increases the effect of increases in the RMB relative to the U.S. dollars, it would make our products more expensive in global markets, such as the United States and the European Union. This could result in the loss of customers, who may seek, and be able to obtain, products and services comparable to those we offer in lower-cost regions of the world. If we did not increase our prices to pass on the effect of increases in the RMB relative to the U.S. dollars, our margins and profitability would suffer.

**Restrictions on the convertibility of RMB into foreign currency may limit our ability to transfer excess funds or dividends to the company's subsidiaries outside China.**

Our manufacturing operations are conducted by our subsidiaries located in China and funds are frequently transferred into our subsidiaries in China. Thus, any future restrictions on currency exchanges may limit our ability to transfer excess funds or dividends outside China. Although the PRC government introduced regulations in 1996 to allow greater convertibility of RMB for current account transactions, significant restrictions still remain, including primarily the restriction that foreign-invested enterprises may only buy, sell and/or remit foreign currencies at those banks authorized to conduct foreign exchange business after providing valid commercial documents. The Chinese regulatory authorities may impose more stringent restrictions on the convertibility of RMB, especially with respect to foreign exchange transactions.

**Political and economic instability of Hong Kong and Macao could harm our operations.**

Our administration and accounting office are located in Macao, formerly a Portuguese Colony and some of our customers and suppliers are located in Hong Kong, formerly a British Crown Colony. Sovereignty over Macao and Hong Kong was transferred to China effective on December 20, 1999 and July 1, 1997, respectively. Since their transfers, Macao and Hong Kong have become Special Administrative Regions of China, enjoying a high degree of autonomy except for foreign and defense affairs. Moreover, China's political system and policies are not practiced in Macao or Hong Kong. Under the principle of one country, two systems, Macao and Hong Kong maintain legal systems that are different from that of China. Macao's legal system is based on the Basic Law of the Macao Special

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Administrative Region and, similarly, Hong Kong's legal system is based on the Basic Law of the Hong Kong Special Administrative Region. It is generally acknowledged as an open question whether Hong Kong's future prosperity in its role as a hub and gateway to China after China's accession to the World Trade Organization (introducing market liberalization in China) will be diminished. The continued stability of political, economic or commercial conditions in Macao and Hong Kong remain uncertain, and any instability could have an adverse impact on our business.

**Changes in 2007 to the PRC's labor law restrict our ability to reduce our workforce if the economic downturn continues.**

In June 2007, the National People's Congress of the PRC enacted new labor law legislation called the Labor Contract Law, which became effective on January 1, 2008. It formalizes workers' rights concerning overtime hours, pensions, layoffs, employment contracts and the role of trade unions. Considered one of the strictest labor laws in the world, among other things, this new law requires an employer to conclude an open-ended employment contract with any employee who either has worked for the employer for 10 years or more or has had two consecutive fixed-term contracts. An open-ended employment contract is in effect a lifetime, permanent contract, which is terminable only in specified circumstances, such as a material breach of the employer's rules and regulations, or for a serious dereliction of duty. Such employment contracts with qualifying workers would not be terminable if, for example, Deswell determined to downsize its workforce in the event of an economic downturn. Under the 2007 law, downsizing by 20% or more may occur only under specified circumstances, such as a restructuring undertaken pursuant to China's Enterprise Bankruptcy Law, or where a company suffers serious difficulties in production and/or business operations. Also, if we lay off more than 20 employees 10% at one time, we have to communicate with the labor union of our Company and report to the District Labor Bureau. Deswell's entire staff, who are employed to work exclusively within the PRC, is covered by the new law. In response to the worldwide economic downturn, we reduced our workforce by 2000 in fiscal 2009 and another 150 in fiscal 2010. However, we may be forced to further downsize our workforce if global economic conditions do not improve or worsen and may incur much higher costs under China's labor laws if we are forced to do so. Accordingly, this law can be expected to exacerbate the adverse effect of the economic environment on our results of operations and financial condition.

**Our customers are dependent on shipping companies for delivery of our products and interruptions to shipping could materially and adversely affect our business and operating results.**

Generally, we sell our products F.O.B. Hong Kong or F.O.B. China and our customers are responsible for the transportation of products from Hong Kong or China to their final destinations. Our customers rely on a variety of carriers for product transportation through various world ports. A work stoppage, strike or shutdown of one or more major ports or airports could result in shipping delays materially and adversely affecting our customers, which in turn could have a material adverse effect on our business and operating results. Similarly, an increase in freight surcharges due to rising fuel costs or general price increases could materially and adversely affect our business and operating results.

**Protecting, seeking licenses for or asserting claims over, intellectual property could be costly.**

We usually rely on trade secrets, industry expertise and the sharing with us by our customers of their intellectual property. However, there can be no assurance that intellectual property that we use in our business does not violate rights in such property belonging to others. We may be notified that we are infringing patents, copyright or other intellectual property rights owned by other parties. In the event of an infringement claim, we may be required to spend a significant amount of money to develop a non-infringing alternative or to obtain licenses. We may not be successful in developing alternatives or in obtaining licenses on reasonable terms, if at all. Any litigation, even without merit, could result in substantial costs and could adversely affect our business and operating results.

Our strategy has been to evaluate trade names and trademarks, and to consider seeking patents, where we believe that such trade names, trademarks or patents would be available and adequate to protect our rights to products or processes that we consider material to our business. To the extent we do seek to obtain trade names, trademarks or patents, we may be required to institute litigation in order to enforce them or other intellectual property rights to protect our business interests. Such litigation could result in substantial costs and could adversely affect sales, profitability and growth.





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**We are dependent on customers operating in highly competitive markets and the inability of our customers to succeed in their markets can adversely impact our business, operating results and financial condition.**

The end markets we serve can experience major swings in demand which, in turn, can significantly impact our operations. Our financial performance depends on our customers' ability to compete and succeed in their markets, which, apparently has been, and could continue to be, affected directly by the current global economic conditions. The majority of our customers' products are characterized by rapid changes in technologies, increased standardization of technologies and shortening of product lifecycles. In many instances, our customers have experienced severe revenue erosion, pricing and margin pressures, and excess inventories during the past few years.

**We could suffer losses from corrupt or fraudulent business practices. Conducting business in China is inherently risky.**

Corruption, extortion, bribery, pay-offs, theft, and other fraudulent practices are common in China. For example, in fiscal 2006, we recorded a provision of approximately \$1 million for doubtful sales transactions, consisting of orders primarily from three customers for products of the metallic parts division of our electronic & metallic parts business segment that had been shown as shipped to, and received by, the customers but in fact had been surreptitiously cancelled without shipment. Documentation reflecting the cancellation of the orders was uncovered following the departure of the General Manager of the Company's metallic parts division who, with the assistance of a former Production and Materials Control Supervisor in that division had concealed such documentation. We could suffer additional losses from similar or other fraudulent practices if we are not successful in implementing and maintaining preventative measures.

**Because our operations are international, we are subject to significant worldwide political, economic, legal and other uncertainties.**

We are incorporated in the British Virgin Islands and have subsidiaries incorporated in the British Virgin Islands, Hong Kong, Macao, Samoa and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2010, approximately 60.6% of the net book value of our total identifiable assets was located in China. We sell our products to customers principally in the United States, China, United Kingdom, Hong Kong, Europe and Southeast Asia. Our international operations may be subject to significant political and economic risks and legal uncertainties, including:

changes in economic and political conditions and in governmental policies,

changes in international and domestic customs regulations,

wars, civil unrest, acts of terrorism and other conflicts,

changes in tariffs, trade restrictions, trade agreements and taxation,

difficulties in managing or overseeing foreign operations, and

limitations on the repatriation of funds because of foreign exchange controls.

The occurrence or consequences of any of these factors may restrict our ability to operate in the affected region and decrease the profitability of our operations in that region.

**We depend on our executive officers, senior managers and skilled personnel.**

Our success depends largely upon the continued services of our executive officers as well as upon our ability to attract and retain qualified technical, manufacturing and marketing personnel. Generally, our executive officers and senior managers are not bound by employment or non-competition agreements and we cannot assure you that we will be able to retain them. The loss of service of any of our officers or key management personnel could have a material adverse effect on our business and operating results. We do not have key person insurance on our executive officers. We believe that our future success will depend, in part, on our ability to attract and retain highly skilled executive, technical and management personnel and if we are not able to do so, our business and operating results could be harmed.



**Table of Contents****Compliance with current and future environmental regulations may be costly which could impact our future earnings. Our results could be adversely affected if we have to comply with new environmental regulations.**

Our operations create some environmentally sensitive waste that may increase in the future depending on the nature of our manufacturing operations. The general issue of the disposal of hazardous waste has received increasing attention from Chinese national and local governments and foreign governments and agencies and has been subject to increasing regulation. Currently, relevant Chinese environmental protection laws and regulations impose fines on discharge of waste materials and empower certain environmental authorities to close any facility which causes serious environmental problems. Although it has not been alleged that we have violated any current environmental regulations by China government officials, the Chinese government could amend its current environmental protection laws and regulations. Our business and operating results could be materially and adversely affected if we were to increase expenditures to comply with environmental regulations affecting our operations.

In addition, we could face significant costs and liabilities in connection with product take-back legislation, which enables customers to return a product at the end of its useful life and charge us with financial and other responsibility for environmentally safe collection, recycling, treatment and disposal. We also face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of our electronic products, including the restrictions on lead and certain other substances in electronics that apply to specified electronics products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS)). The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU countries have required their suppliers to be compliant with the new directive. Many of these customers in our electronic division have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such event, we could experience the loss of revenue, damaged reputation, diversion of resources, monetary penalties, and legal action. Other environmental regulations may require us to reengineer our products to utilize components that are more environmentally compatible. Such reengineering and component substitution may result in additional costs to us. Although we currently do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on us.

**Power shortages in China could affect our business.**

We consume substantial amounts of electricity in our manufacturing processes at our production facilities in China. Certain parts of China, including areas where our manufacturing facilities are located, have been subject to power shortages in recent years. We have experienced a number of power shortages at our production facilities in China to date. We are sometimes given advance notice of power shortages and in relation to this we currently have a backup power system. However, there can be no assurance that in the future our backup power system will be completely effective in the event of a power shortage, particularly if that power shortage is over a sustained period of time and/or we are not given advance notice of it. Any power shortage, brownout or blackout for a significant period of time may disrupt our manufacturing, and as a result, may have an adverse impact on our business.

**A material failure of internal control over financial reporting could materially impact the Company's financial results.**

In designing and evaluating its internal control over financial reporting, management recognizes that any internal control or procedure, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Management believes that the Company's internal control over financial reporting currently provides reasonable assurance of achieving their control objectives. However, no system of internal controls can be designed to provide absolute assurance of effectiveness. See Item 15 Controls and Procedures, below. A material failure of internal control over financial reporting could materially impact the Company's reported financial results and the market price of its stock could significantly decline. Additionally, adverse publicity related to a material failure of internal control over financial reporting could have a negative effect on the Company's reputation and business.



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**Potential new accounting pronouncements are likely to impact our future financial position and results of operations and in the case of FASB's pronouncement regarding the expensing of stock options have adversely impacted, and will in the future, adversely impact our financial results.**

Deswell prepares its financial statements in conformity with the generally accepted accounting principles of the United States of America—US GAAP. A change in these accounting principles and policies, especially as interpreted by the Securities and Exchange Commission and The NASDAQ Stock Market, may have an impact on our future financial position and results of operations. Historically, regulatory changes, such as the requirement of the Financial Accounting Standards Board to expense stock options grants, and other legislative initiatives have increased our general and administrative costs and future changes could have a similar adverse impact on our financial results.

**The concentration of share ownership in our senior management allows them to control or substantially influence the outcome of matters requiring shareholder approval.**

On June 30, 2010, members of our senior management and Board of Directors as a group beneficially owned approximately 20.4% of our outstanding common shares. As a result, acting together, they may be able to control or at least substantially influence the outcome of all matters requiring approval by our shareholders, including the election of directors and approval of significant corporate transactions. This ability may have the effect of delaying or preventing a change in control of Deswell, or causing a change in control of Deswell that may not be favored by our other shareholders.

**Our board's ability to amend our charter without shareholder approval could have anti-takeover effects that could prevent a change in control.**

As permitted by the law of the British Virgin Islands, our Memorandum and Articles of Association, which are the terms used in the British Virgin Islands for a corporation's charter and bylaws, may be amended by our board of directors without shareholder approval provided that a majority of our independent directors do not vote against the amendment. This includes amendments to increase or reduce our authorized capital stock or to create from time to time and issue one or more classes of preference shares (which are analogous to preferred stock of corporations organized in the United States). Our board's ability to amend our charter documents without shareholder approval, including its ability to create and issue preference shares, could have the effect of delaying, deterring or preventing a change in control of Deswell, including a tender offer to purchase our common shares at a premium over the then current market price.

**Our exemptions from certain of the reporting requirements under the Exchange Act limits the protections and information afforded to investors.**

We are a foreign private issuer within the meaning of rules promulgated under the Securities Exchange Act of 1934. As a foreign private issuer, we are exempt or excluded from certain provisions applicable to United States public companies including:

the rules under the Exchange Act requiring the filing with the Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;

the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect to a security registered under the Exchange Act;

the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer's equity securities within less than six months); and

Regulation FD, the SEC's rules regulating disclosure of information by publicly traded companies and other issuers and requiring that when an issuer discloses material nonpublic information to certain individuals or entities such as stock analysts, or holders of the issuer's securities who may trade on the basis of the information, the issuer must make public disclosure of that information.

In addition, because we are a foreign private issuer, certain of the corporate governance standards of The NASDAQ Stock Market that are applied to domestic companies having securities included on The NASDAQ Stock

Market are not applicable to us. For example, as a foreign private issuer organized under the law of the British

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Virgin Islands, we may follow our home company practice in lieu of some of the corporate governance provisions of sections 5600 *et. seq.* of NASDAQ's Marketplace Rules. Accordingly, as the law of the British Virgin Islands does not prohibit us from doing so and since our practices are in compliance with our Memorandum and Articles of Association, we follow our home company practices with respect to the following NASDAQ Market Place rules:

*Rule 5605(b)(2)*: Our independent directors do not meet in executive session;

*Rule 5605(d)*: Our board does not have a compensation committee and compensation of our Chief Executive Officer and other executive officers is neither determined nor recommended to the board by a majority of our independent directors; and

*Rule 5605(e)*: Nominees for appointment as our directors are not selected or recommended by either a majority of our independent directors, or a nominating committee composed solely of independent directors.

Although we may also follow our home company practice in lieu of NASDAQ's Marketplace Rule 5605(b)(1) requiring the independence of a majority of our directors, during the year ended March 31, 2010 to date, the composition of our Board of Director has consisted of a majority of directors deemed independent under that Rule.

Because of these exemptions or exclusions, investors are not afforded the same protections or information generally available to investors in public companies organized in the United States and having securities included on The Nasdaq Stock Market.

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**Item 4. INFORMATION ON THE COMPANY**

**Corporate Information**

Deswell Industries Inc. was founded in 1987 in Hong Kong and moved its manufacturing operations to China in 1990 to take advantage of lower overhead cost, competitive labor rate and tax concessions available in Shenzhen, China as compared with Hong Kong. We were reincorporated in December 1993 as a limited liability International Business Company under the laws of the British Virgin Islands. The Company's registered agent in the British Virgin Islands is Harneys Corporate Services Limited, P.O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands. The Company's principal administrative office is located in 17B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao, and its telephone number is (853) 28322096 and its facsimile number is (853) 28323265. Our principal manufacturing facilities and operations are currently based in Dongguan, Guangdong, China.

**Important Events in Deswell's Development that Have Occurred since April 1, 2009**

In August 2009, Deswell entered into an agreement with a third party to sell real property in Shekou, Shenzhen, China that was formerly used for its plastic injection molding operations for RMB 50,000,000 (approximately \$7.3 million, based on an exchange rate of 1:6.8309 on August 5, 2009 as reported on <http://forex-history.net>). The Company originally purchased the property, which consists of approximately 112,900 square feet of manufacturing space, in fiscal 2001 for approximately \$1,461,000. In 2007, the Company completed the transition of its injection molding plastic manufacturing operations to a newly constructed and substantially larger facility in Houjie, Dongguan, China, closed the Shekou plant and held it for sale until the sale was consummated.

After required local government transfer and other approvals were obtained, the sale closed during the Company's second fiscal quarter ended September 30, 2010. Deswell recorded a gain on the sale, net of transaction costs, of \$4.2 million for its year ended March 31, 2010.

Following the sale, Deswell applied to deregister Jetcrown Industrial (Shenzhen) Limited, its subsidiary which held the real property that was sold. The PRC regulatory authority approved the deregistration of that subsidiary effective on March 24, 2010.

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**Organizational Structure**

The following diagram illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2010.

**Table of Contents****Capital Expenditures**

Principal capital expenditures and divestitures made by Deswell during the three years in the period ended March 31, 2010 include the following (dollar amounts in thousands):

|   | <b>Year ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Purchase of property, plant and equipment   | \$7,288                     | \$7,402     | \$1,606     |
| Proceeds from the sale of property, plant and equipment, net of transaction costs | 333                         | 345         | 5,528       |
| Acquisition of non-controlling interest in a subsidiary                           | 414                         |             |             |

Our major capital expenditures in fiscal 2010 included:

\$0.5 million for land and buildings, and leasehold improvements;

\$0.6 million for furniture, fixtures and equipment;

\$0.5 million for motor vehicles.

Our major capital expenditures in fiscal 2009 included:

\$1.1 million for land and buildings, and leasehold improvements;

\$3.7 million for plant and machinery for production of plastic and electronic products;

\$2.6 million for furniture, fixtures and equipment.

Our major capital expenditures in fiscal 2008 included:

\$1.3 million for land and buildings mainly used as dormitory for management;

\$2.7 million for plant and machinery for production of plastic and electronic products;

\$2.0 million for furniture, fixtures and equipment;

\$0.3 million for motor vehicles;

\$1.0 million for leasehold improvements.

All of the foregoing capital expenditures were financed principally from internally generated funds and our current plan is to continue to use internally generated funds principally to finance future capital expenditures.

As of March 31, 2009, the Company had completed the first three phases to construct its own manufacturing plant and dormitory buildings in Houjie, Dongguan China with an aggregate of approximately 1.3 million square feet of land acquired from the local government in January 2000. Through March 31, 2009, we had spent an aggregate of \$58 million to equip and furnish the plant and buildings for operations.

Phase IV of construction, to consist of planned additional two dormitory units and two other buildings, is planned for the long-term. We intend to commence construction with internally generated funds when we believe that additional production capacity may be required in the future. However, we may choose to obtain debt or equity financing if we believe it appropriate to accelerate the last phase of the construction of our facilities or for future expansion.

**Business Overview**

We are an independent manufacturer of injection-molded plastic parts and components, electronic products and subassemblies and metallic molds and accessory parts for original equipment manufacturers, or OEMs and contract manufacturers. We conduct all of our manufacturing activities at separate plastics, electronics and metallic operation factories located in the People's Republic of China. Beginning in January 2005, we also began to engage in the business of distributing audio equipment in China.

We produce a wide variety of plastic parts and components that are used in the manufacture of consumer and industrial products, using different plastic injection technologies, such as film injection, integrated injection and insert injection. The products include:

Plastic component of electronic entertainment products;

cases for flashlights, telephones, paging machines, projectors and alarm clocks;

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toner cartridges and cases for photocopy and printer machines;

parts for electrical products such as air-conditioning and ventilators;

parts for audio equipment;

cases and key tops for personal organizers and remote controls;

double injection caps and baby products;

parts for medical products such as apparatus for blood tests;

laser key caps; and

automobile components.

Electronic products manufactured by the Company include

sophisticated professional audio equipment including digital audio workstation, digital or analogue mixing consoles, instrument amplifiers, signal processors, firewire/USB audio interfaces, keyboard controllers and speaker enclosures;

high end home theatre audio products, such as 7.1-channel audio-visual Hi-Fi stereo receivers-amplifiers;

complex printed circuit board assemblies using surface mount technology ( SMT ), automatic insertion ( AI ) and pin-through-hole ( PTH ) interconnection technologies and

telecommunication products, such as VoIP keysets for business communications.

Metal products manufactured by the Company include metallic molds and accessory parts used in audio equipment, telephones, copying machines, pay telephones, multimedia stations, automatic teller machines, vending machines, etc.

As part of its manufacturing operations, the Company consults with its customers in the design of plastic parts and the design and production of the molds used to manufacture plastic parts, which are made by Deswell at its customers expense, and provides advice and assistance in the design and manufacturing of printed circuit boards. The Company believes that its ability to manufacture high-end plastic and metal parts of the quality required by OEMs and contract manufacturers which furnish products and services internationally, Deswell s expertise in designing and manufacturing molds for its customers and the Company s low production costs distinguish Deswell from most other manufacturers of plastic products and provide it with a competitive advantage. However, this advantage has been difficult to maintain as a result of increased competition and increased production overheads during the last three fiscal years.

**Industry Overview**

Management believes that the injection molding and metal molds and parts manufacturing industries have each benefited in recent years from a trend among major users of injection molded and metal products to outsource an increasing portion of the parts requirements and to select a small number of suppliers or a sole supplier to provide those products. The Company is not aware of any empirical data defining the manufacturing industry in China, however, management believes that injection molding and metal manufacturing firms which are much smaller than the Company make up the largest segment of the industry in China. The Company s experience indicates that such smaller firms are often unable to react quickly and responsively to the diverse demands of many customers and are not capable of furnishing the level of quality that high-end plastic and metal products require. Management believes that this inability on the part of these smaller manufacturers has created opportunities for the Company to increase sales by catering to the outsourcing requirements of OEMs and contract manufacturers that manufacture such high-end products.

Similarly, as a result of the recognition by OEMs in the electronics industry of the rising costs of operating a manufacturing site and the need to add more sophisticated and expensive manufacturing processes and equipment, OEMs have turned increasingly to outside contract manufacturers. By doing so, OEMs are able to focus on research, product conception, design and development, marketing and distribution, and to rely on the production expertise of contract manufacturers. Other benefits to OEMs of using contract manufacturing include: access to manufacturers in regions with low labor and overhead costs, reduced time to market, reduced capital investment, improved inventory management, improved purchasing power and improved product quality. In addition, the use of contract manufacturers has helped OEMs manage production in view of increasingly shorter product life cycles.

**Table of Contents****Operations****Plastic Injection Molding**

Plastic injection molding manufacturing accounted for 40.9%, 55.7% and 57.6% of the Company's total sales during the years ended March 31, 2008, 2009 and 2010, respectively. At March 31, 2010, the Company conducted its plastic manufacturing operations in approximately 1,070,000 square feet of factory space in its factory located in Dongguan, Guangzhou, China.

The Company's plastic injection molding process consists of three phases: (1) mold design and production; (2) plastic injection; and (3) finishing.

*Mold design and production*

The plastic injection-molding process begins when a customer provides the Company with specifications for a product or part, which specifications are often created in consultation with the Company's technical staff. Next the Company designs and produces the mold, using great care in the design process and in the selection of materials to produce the mold in an effort to create a high quality appearance of the completed product by reducing or eliminating potential flaws such as the sinkage of materials and irregularities in the knit line of joints. The mold-making process ranges from 30 to 110 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive. At March 31, 2010, the Company used 30 EDMs (electrical discharge machines), 32 CNC (computer numerical control) milling machines and 83 NC (numerical control) milling machines in the mold-making process.

Molds produced by the Company generally weigh from 110 to 17,600 pounds and generally cost between \$2,000 and \$200,000.

The customer generally bears the cost of producing the molds and, as is customary in the industry, the customer owns them. However, the Company maintains and stores the molds at its factory for use in production and it is Deswell's policy generally not to make molds for customers unless the customer undertakes to store its molds at the Company's factory and uses Deswell to manufacture the related parts. In that way, the Company seeks to use its mold-making expertise to create dependence on it for the customer's parts requirements. Beginning in 2005, however, through its then newly created Export Tooling Department, Deswell's began producing molds for export to customers and thus does not use those molds to manufacture related parts.

During the year ended March 31, 2010, the Company made on average about 15 to 70 different molds every month. Management believes that the Company's skills and expertise in mold-making, coupled with having its facilities and operations in China, allow the Company to produce molds at costs substantially less than molds of comparable quality made in Japan, Korea and Taiwan.

*Plastic Injection*

During the mold-making process, suitable plastic resin for the particular product is selected and purchased. See Raw Materials, Component Parts and Suppliers, below. The completed mold is mounted onto injection machines, which are classified according to the clamping force (the pressure per square inch required to hold a mold in place during the injection molding process). At March 31, 2010, the Company had approximately 420 injection molding machines, ranging from 22 to 1,600 tons of clamping force, with most machines in the range of from 55 to 380 tons. Each of the Company's machines is capable of servicing a variety of applications and product configurations and the Company has machines, which permit the Company to fabricate plastic parts as small as a button and as large as a 3 ft. x 2 ft. case for a copy machine.

Using separate shifts, injection molding can be conducted 24 hours a day, five to seven days per week, other than during normal down time for maintenance and changing of product molds. Molding of products requiring extra concerns for appearance, such as cases for calculators, personal organizers and telephones are conducted in an isolated and dust free section of the factory. In a continuous effort to assure quality, the Company's quality control personnel inspect the products produced from each machine generally at hourly intervals during production. When defects are discovered, the Company's maintenance personnel inspect the mold and the machine to determine which is responsible. If the mold is the cause of the defect, it will be immediately removed from the machine and serviced or repaired by one of a team of technicians employed to maintain molds. The mold will then be remounted on the machine and production will continue. If the machine is the source of the defect, the Company's technicians and

engineers service the machine immediately. Through this continuous vigilance to molds and machines, the Company has experienced what it believes to be a relatively low scrap rate and has been able to maintain a high level of productivity of its injection molding machines.

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During the year ended March 31, 2008, the Company acquired 22 new plastic injection molding machines for approximately \$1.6 million, replacing 20 old injection molding machines. In fiscal 2009, the Company purchased 53 new plastic injection molding machines for approximately \$1.7 million, replacing 25 old injection molding machines. In the year ended March 31, 2010, the Company did not acquire any new plastic injection molding machines.

*Finishing*

After injection molding, products are finished. Finishing consists of smoothing and polishing, imprinting letters, numbers and signs through silk screening process, pad printing or epoxy ultra violet cutting, and treating the product with an anti-fog coating for a lasting and attractive appearance. Most of these functions are conducted by hand.

**Electronic Products and Assemblies**

In an aggregate of approximately 223,000 square feet of factory space at March 31, 2010 located at facilities in Dongguan, China, the Company manufactures and assembles electronic products and electronic assemblies for OEMs. Finished products include consumer and sophisticated studio-quality audio equipment, IPBX and commercial telephone units, network education platforms, IP switches, routers etc. Assemblies consist of PCBs with passive (e.g., resistors, capacitors, transformers, switches and wire) and active (e.g., semiconductors and memory chips) components mounted on them. During the years ended March 31, 2008, 2009 and 2010, manufacturing of electronic products accounted for approximately 56.7%, 43.4% and 42.4%, respectively, of the Company's total sales.

In assembling printed circuit boards the Company purchases printed circuit boards, surface mounted components and chips and uses automatic insertion and pin-through-hole interconnection technologies to assemble various components onto the PCBs. Before delivery, completed PCBs are checked by in-circuit-testers and outgoing quality assurance inspections are performed.

PTH is a method of assembling printed circuit boards in which component leads are inserted and soldered into plated holes in the board. While this technology is several decades old and is labor intensive, it still has a significant market, particularly for consumer product applications.

BGA is a method of mounting an integrated circuit or other component to a PCB. Rather than using pins that consume a large area of the PCB, the component is attached to the circuit board with small balls of solder at each contact. This method allows for greater component density and is used in more complex PCBs.

SMT is the automatic process of printed circuit board assembly in which components are mounted directly to the surface of the board, rather than being inserted into holes. With this process, solder is accurately stenciled in paste form on pads located on the printed circuit board and the components are then placed onto the solder paste and fused to the melting point of the paste to establish a strong solder joint between components and the printed circuit board. The SMT process allows miniaturization of PCBs, cost savings and shorten lead paths between components (which results in faster signal speed and improved reliability). Additionally, it allows components to be placed on both sides of the printed circuit board, a major factor for the purpose of miniaturization.

Manufacturing operations include PCB assembly, wiring and testing. The process is completed by assembling the PCBs into a plastic or metal housing that comprises the finished product. Quality assurance is then conducted in accordance with the customers' requirements before the shipment.

**Metal Parts Manufacturing**

In an aggregate of approximately 111,000 square feet of factory space at March 31, 2010 located at facilities in Dongguan, China in the same complex and next to the Company's electronic products assembly facilities, Deswell's metal forming division manufactures metallic molds and accessory parts for use in audio equipment, routers, payphones, multimedia stations and ATMs. The Company's metal molds and metal parts (products) manufacturing accounted for approximately 2.4% of Deswell's total sales during the year ended March 31, 2008 and less than one percent of Deswell's total sales during each of the years ended March 31, 2009 and 2010.

**Quality Control**

The Company maintains strict quality control procedures for its products. At hourly intervals, the Company's quality control personnel monitor machines and molds to assure that plastic parts are free from defects.

For electronic operations, the Company's quality control personnel check all incoming components. Moreover, during the production stage, the Company's quality control personnel check all work in process at several





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points in the production process. Finally, after the final assembly and before shipment, the Company conducts quality assurance inspections in accordance with the customers' Acceptable Quality Level, or AQL, requirements.

Plastic, electronic and metal products manufactured and assembled at the Company's facilities have a low level of product defects, and aggregate returns represented less than 3% of total net sales during each of the years ended March 31, 2008, 2009 and 2010.

In 1995, the Company earned ISO 9001 certifications for both its plastic and electronic products manufacturing operations. In April 2000, the Company also received ISO 9002 for its metal manufacturing operation. The ISO or International Organization for Standardization is a Geneva-based organization dedicated to the development of worldwide standards for quality management guidelines and quality assurance. ISO 9000, which is the first quality system standard to gain worldwide recognition, requires a company to gather, analyze, document and monitor and to make improvements where needed. ISO 9001 is the ISO level appropriate for manufacturers like the Company. The Company's receipt of ISO 9001 certification demonstrates that the Company's manufacturing operations meet the established world standards.

In August 2004, the Company's plastic injection manufacturing plant in Dongguan also obtained ISO 14001 certification, which evidences that the Company's environmental management standards or EMS meet established international standards. ISO 14000 is a series of international standards on environmental management, ISO 14001 is the most well-known of these standards and is often seen as the corner stone standard of the ISO 14000 series. In January 2006, the Company's electronic and metallic manufacturing plant also obtained ISO 14001 certification.

The Company was working toward having its plastic injection manufacturing plant to obtain QS 9000 Certification but before completing that process elected to seek ISO/TS 16949 Certification. ISO/TS 16949 is an ISO Technical Specification. This specification aligns existing American (QS-9000), German (VDA6.1), French (EAQF) and Italian (AVSQ) automotive quality systems standards within the global automotive industry. Together with ISO 9001:2000, ISO/TS 16949 specifies the quality system requirements for the design/development, production, installation and servicing of automotive related products. ISO/TS 16949 has been accepted as an equivalent to QS-9000, VDA6.1, AVSQ, and EAQF. ISO/TS 16949 does not replace QS-9000; but is optional and eliminates the need for multiple certifications. Deswell obtained ISO/TS 16949 Certification in July 2006.

**Raw Materials, Component Parts and Suppliers***Plastic Resins.*

The primary raw materials used by the Company in the manufacture of its plastic parts are various plastic resins, primarily ABS (acrylonitrile-butadiene-styrene). The chart shows Deswell's average cost of ABS as a percentage of the total cost of plastic products sold and as a percentage of total cost of goods sold during its last three fiscal years.

Because plastic resins are commodity products, the Company selects its suppliers primarily based on price. The Company has no long-term supply agreements for plastic resins. The Company currently obtains majority of its plastic resins from suppliers in the United States, Malaysia, Singapore, Taiwan, Japan and Hong Kong and the remaining from suppliers in Mainland China and normally maintains a two to three month inventory supply.

The Company used in excess of 14,330,000 pounds of plastic resins during the year ended March 31, 2010. Management believes that the Company's large volume purchases of plastic resin have generally resulted in lower

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unit raw material costs and generally has enabled the Company to obtain adequate shipments of raw materials. While the Company is not generally bound by fixed price contracts with its customers, the Company has found that increases in resin prices can be difficult to pass on to its customers and, as a consequence, a significant increase in resin prices could have, and in the past has had, a material adverse effect on the Company's operations.

The primary plastic resins used by the Company are produced from petrochemical intermediates derived from products of the natural gas and crude oil refining processes. Natural gas and crude oil markets have in the past experienced substantially cyclical price fluctuations as well as other market disturbances including shortages of supply and crises in the oil producing regions of the world. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are also subject to cyclical and other market factors. Consequently, plastic resin prices may fluctuate as a result of natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced.

Although the plastics industry has from time to time experienced shortages of plastic resins, the Company has not experienced to date any such shortages. Management believes that there are adequate sources available to meet the Company's raw material needs.

*Component Parts and Supplies*

The Company purchases a wide variety of component parts from numerous suppliers and is not dependent upon any single supplier for any essential component. The Company purchases from suppliers in China, Hong Kong, the United States and elsewhere. At various times there have been shortages of parts in the electronics industry, and certain components, including PCBs and semiconductors, have been subject to limited allocations. Although shortages of parts and allocations have not had a material adverse effect on the Company's results of operations, there can be no assurance that any future shortages or allocations would not have such an effect.

*Raw Metal*

The primary materials used by the Company in metal molds and parts manufacturing are various metals, but purchases of raw metal were immaterial to the Company's total operations during the years ended March 31, 2008, 2009 and 2010. Typically, the Company buys metals from a variety of suppliers in Hong Kong and China and has no long-term contracts with metal suppliers.

**Transportation**

Transportation of components and finished products to customers in Shenzhen and to and from Hong Kong and Shenzhen and Dongguan is by truck. Generally, the Company sells its products F.O.B. China or F.O.B. Hong Kong. To date, the Company has not been materially affected by any transportation problems and has found that the transition of Hong Kong to Chinese control in July 1997 has not had an adverse impact on the Company's ability to transport goods to and from Hong Kong and China.

**Customers and Marketing**

The Company's customers are OEMs and contract manufacturers. The Company sells its products in the United States, Asia (China, Hong Kong and Thailand) and Europe (United Kingdom, Holland, Norway and Germany). Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company's customers. For example, if the products are delivered to the customer in Hong Kong, the sales are recorded as generated in Hong Kong; if the customer directs the Company to ship its products to Europe, the sales are recorded as sold to Europe. See Note 14 of Notes to Consolidated Financial Statements for the dollar amounts of export sales by geographic area for each of the years ended March 31, 2008, 2009 and 2010. Net sales as a percentage of total sales to customers by geographic area consisted of the following for the years ended March 31, 2008, 2009 and 2010:

| <b>Geographic Areas</b> | <b>Year ended March 31,</b> |             |             |
|-------------------------|-----------------------------|-------------|-------------|
|                         | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| China                   | 37.0%                       | 52.8%       | 52.5%       |
| United States           | 46.8                        | 32.0        | 44.3        |
| Europe                  | 10.7                        | 12.4        | 2.0         |
| Hong Kong               | 1.7                         | 1.3         | 0.7         |
| Others                  | 3.8                         | 1.5         | 0.5         |

|       |        |        |        |
|-------|--------|--------|--------|
| Total | 100.0% | 100.0% | 100.0% |
|-------|--------|--------|--------|

We believe that our reported sales by geographic area in the above table do not necessarily reflect the final destinations of our products or the actual nationalities of our customers. For example, we have reported product sales in China amounting to 52.5% of our total net sales for the year ended March 31, 2010 because China is where

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our customers directed us to deliver the products. However, we believe that these sales were to offshore customers using local China shipping destinations, which in turn, transshipped our products offshore.

The Company markets its products and services to existing customers through direct contact with the Company's management and direct sales personnel. The Company's sales personnel attend trade shows and the Company advertises in trade publications such as *Modern Plastics International* and *Injection Molding*. Collecting information from trade-show, as well as websites, Deswell's marketing staffs contacts existing and potential customers directly by telephone, mail, fax, e-mail via the Internet and in person, stressing Deswell's capability as a complete solution provider for plastic injection mold design, tooling and molding as well as an electronics manufacturing services, or EMS, provider of advanced technology manufacturing processes and flexible logistic services.

**Major Customers**

The table below sets forth each of the Company's customers which accounted for 10% or more of net sales during the year ended March 31, 2010, the category of products purchased and the percentage of total Deswell net sales from such customers during the years ended March 31, 2008, 2009 and 2010.

| Customer                         | Product                      | Year ended March 31, |       |       |
|----------------------------------|------------------------------|----------------------|-------|-------|
|                                  |                              | 2008                 | 2009  | 2010  |
| N&J Company Limited              | Plastic Component            | 11.8%                | 28.6% | 19.2% |
| Digidesign, Inc.                 | Professional audio equipment | 17.0                 | 12.7  | 12.0  |
| Vtech Telecommunications Limited | Plastic component            | *                    | *     | 10.8  |

\* Less than 10%.

The Company's success will depend to a significant extent on the success achieved by its customers in developing and marketing their products, some of which may be new. Many of the industry segments served by the Company's customers are subject to technological change, which can result in short product life cycles. The Company could be materially adversely affected if advances in technology or other factors reduce the marketability of essential products of its customers or if new products being developed by its customers do not attain desired levels of acceptance. If the Company was to lose any customers who account for a material portion of total net sales, or if any of these customers were to decrease substantially their purchases from the Company, the Company's revenues, earnings and financial position would be materially and adversely affected. The Company's dependence on a limited number of customers is expected to continue in the foreseeable future. See the discussion under *We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us. These risks have become particularly acute in the current adverse economic environment* in Item 3 Key Information Risk Factors, above.

The Company's sales transactions with all of its customers are based on purchase orders received by the Company from time to time. Except for these purchase orders, the Company has no written agreements with its customers. Sales of plastic parts, electronic products and metallic products are primarily made on credit terms, with payment in United States dollars or Hong Kong dollars expected within 30 to 90 days of shipment. In certain cases, primarily new customers of electronic products, sales are supported by letters of credit and are payable in United States dollars. To date, the Company has not experienced any significant difficulty in collecting accounts receivable on credit sales. Management communicates regularly with credit sale customers and closely monitors the status of payment and in this way believes it has kept the default rate low. Additionally, plastic parts deliveries are made in several installments over a lengthy period of time, which permits the Company to withhold delivery in the event of any delinquency in payment for past shipments. While the Company has not experienced any difficulty in being paid by its major customers, there can be no assurance that the Company's favorable collection experience will continue in every case or at all. The Company could be adversely affected if a major customer were unable to pay for the Company's products or services.

**Competition**

We compete with a number of different companies in producing of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. For example, we compete with major global EMS providers, other smaller EMS companies that have a regional or product-specific focus, and original design manufacturers with respect to some of the services that we provide. We also compete with our current and prospective customers, who evaluate our capabilities in light of their own capabilities and cost structures. Our market segments are extremely competitive, many of our competitors have achieved substantial market share and many have lower cost structures and greater manufacturing, financial or other resources than we

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do. We face particular competition from Asian-based competitors, including Taiwanese EMS providers who compete in our end markets.

The Company believes that competition for plastic injection molding, contract electronic manufacturing and metal molds and parts manufacturing businesses are based on price, quality, service and the ability to deliver products in a timely and reliable basis.

### **Patents, Licenses and Trademarks**

The Company has no patents, trademarks, licenses, franchises, concessions or royalty agreements that are material to its business.

### **Seasonality**

For information concerning the seasonality of the Company's business, see Seasonality included under Item 5 Operating and Financial Review and Prospects.

### **Property, Plants and Equipment**

#### *Macao*

The Company leases Units 17B and 17E, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao from an unaffiliated party, each being for a term of two years to July 2012. The premises are used as trading, administrative and accounting office for the Company's plastic injection business and electronic & metallic business, respectively. The monthly rent is approximately \$2,350.

#### *Southern China*

In January 2000, the Company acquired under a land-lease agreement with the local government an aggregate of approximately 1.3 million square feet of land to construct its own manufacturing plant and dormitory buildings in Houjie, Dongguan, China. Under the land-lease agreement, the Company has the right to use the land for 50 years. On this land, Deswell has through March 31, 2010 constructed approximately

1,070,000 square feet of factory space,

91,000 square feet of amenity space,

133,000 square feet of office building space, and

470,000 square feet of dormitory space.

Deswell now uses this facility for its plastic manufacturing operations. For information regarding Deswell's sale to a third party of property which Deswell previously used for its plastic injection molding operations, see the discussion under Item 4 Information on the Company's Important Events in Deswell's Development that Have Occurred since April 1, 2009 at page 18, and Item 10 Additional Information Material Contracts page 47, of this Report.

The Company owns 12 apartment units located near its plastic manufacturing factories that are used for housing senior management. At March 31, 2010, the Company leased one dormitory for factory staff near its plastics manufacturing factories in Dongguan. The dormitory is leased for a period of one year expiring in April 2011. The aggregate monthly rental is approximately \$400.

In July 2003, the Company acquired under a land-lease agreement with a third party an aggregate of approximately 244,000 square feet of land and approximately 420,000 square feet of buildings, including six blocks of dormitory buildings, a canteen, a factory building, a car park and a guard room, at Chang An, Dongguan, China, which was previously named Kwan Hong Building. The land use period is for 50 years from February 1, 2003 to January 31, 2053. The Company uses the facilities for its electronic products manufacturing operations.

At March 31, 2010, the Company leased approximately 69,400 square feet of manufacturing space in Chang An, Dongguan, China for its contract metal manufacturing operations. These premises are leased from a third party and the lease expires in May 2013. The aggregate monthly rental is approximately \$8,400.

In addition, the Company leases approximately 4,000 square feet of space at various locations near its contract electronics and metal manufacturing factories in Dongguan, which are used as staff quarters. The facilities are leased from third parties for period of one year and such leases expire from June 2010 to March 2011. The aggregate monthly rental is approximately \$1,800.

Management believes that Deswell will be able to renew each of the leases described above as it expires for periods comparable to the current term or find alternative space as needed.



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The Company believes that its existing offices and manufacturing space, and manufacturing space in close proximity to its existing facilities, which management believes will be available as needed for limited expansion, will be adequate for the operation of its business for at least the next two years.

**Item 4A. UNRESOLVED STAFF COMMENTS**

Not applicable to Deswell.

**Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties. You can identify these statements by forward looking words including expect, anticipate, believe, seek, estimate. Forward looking statements are not guarantees of Deswell's future performance or results and the Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under the section of this Report entitled Item 3. Key Information Risk Factors.

**Operating Results**

The following discussion should also be read in conjunction with the consolidated financial statements and notes thereto included following Item 18 of this Report. The Company prepares its financial statements in accordance with U.S. GAAP.

**General**

The Company's revenues are derived from the manufacture and sale of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. Jetcrown Macao and Jetcrown Dongguan (wholly owned subsidiaries) carry on the plastics operations whereas Integrated carries out the electronics and metallic operations. The Company acquired a controlling interest in Integrated's predecessor in October 1992 and has included the results of the predecessor in its consolidated financial statements from the date of acquisition. Through December 2002, the Company owned a 51% interest in Integrated. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from its minority shareholders in exchange for the issuance to them of an aggregate of 251,880 common shares. In April 2005, the Company increased its interest in Integrated to 76% by purchasing an additional 5% from a minority shareholder in exchange for the issuance to it of 120,000 common shares. In August 2007, the Company further increased its interest in Integrated to 100% by purchasing the remaining 24% from the minority shareholders in exchange for the issuance to them of 632,080 common shares and a cash payment of \$414,000.

The Company's plastics operations are the mainstay of its business and have historically accounted for the majority of its sales. The Company carries out all of its manufacturing operations in Southern China, where it is able to take advantage of the lower overhead costs and inexpensive labor rates as compared to Hong Kong. At the same time, the proximity of the Company's factories in Southern China to Hong Kong permits the Company to manage easily its manufacturing operations from Macao, facilitates transportation of its products through Hong Kong and provides the Company's plastic manufacturing operations with access to electricity from Hong Kong and to nearby water, both of which resources are needed in abundance to manufacture plastic parts and are often inadequate elsewhere in China.

Under PRC tax law in effect before January 1, 2008, we have been afforded a number of tax concessions by, and tax refunds from, China's tax authorities on a substantial portion of our operations in China by reinvesting all or part of the profits attributable to our PRC manufacturing operations. We have enjoyed preferential tax concessions in the PRC as a high-tech enterprise and have benefited from favorable overall effective income tax rates of 8.70% and 1.13% for the years ended March 31, 2007 and 2008, respectively. However, on March 16, 2007, the Chinese government enacted a new unified enterprise income tax law which became effective on January 1, 2008. Under the new income tax law most domestic enterprises and foreign invested enterprises, like Deswell, would be subject to a single PRC enterprise income tax rate and gradually transfer to the new tax rate of 25% within five years. Following the implementation of the Enterprise Income Tax Law effective January 1, 2008, the State Council announced the transition rules for preferential tax policies (Guofa [2007] No.39) of January 2, 2008, for eligible enterprises previously subject to a 15% tax rate or 24% tax rate. As so announced, the new enterprise income tax rates are:

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| <b>Tax Year (Calendar)</b> | <b>Rate under EIT for enterprises previously<br/>subject to tax rate of</b> |                   |
|----------------------------|---|-------------------|
|                            | <b>15 percent</b>   | <b>24 percent</b> |
| <b>2010</b>                | <b>22%</b>  | <b>25%</b>        |
| <b>2011</b>                | <b>24%</b>  | <b>25%</b>        |
| <b>2012</b>                | <b>25%</b>  | <b>25%</b>        |

Accordingly, with the enactment of new PRC Enterprise Tax effective January 1, 2008, the Company expects the benefits it previously enjoyed, such as receiving tax refunds as a result of its reinvestment of profits in certain of its subsidiaries in China and favorable concession rates, will no longer be available.

Deswell's material operations are generally organized in two segments: plastic injection molding, or the plastic segment, electronic products assembling and metallic parts manufacturing. Results from Company's metallic parts manufacturing operations have not been material to the Company's operations as a whole and have therefore been combined as the electronic and metallic segment for the table presentation and discussion below. The Company's reportable segments are strategic business units that offer different products and services. The following table sets forth present selected consolidated financial information stated as a percentages of net sales for each of the three years in the period ended March 31, 2010.

|   | <b>Year ended March 31, 2008</b>         |  |              | <b>Year ended March 31, 2009</b>         |  |              | <b>Year ended March 31, 2010</b>         |  |              |
|---|--|--|--------------|--|--|--------------|--|--|--------------|
|   | <b>Plastic Injection Molding Segment</b> | <b>Electronic &amp; Metallic Segment</b> | <b>Total</b> | <b>Plastic Injection Molding Segment</b> | <b>Electronic &amp; Metallic Segment</b> | <b>Total</b> | <b>Plastic Injection Molding Segment</b> | <b>Electronic &amp; Metallic Segment</b> | <b>Total</b> |
| Net sales   | 100.0%                                   | 100.0%                                   | 100.0%       | 100.0%                                   | 100.0%                                   | 100.0%       | 100.0%                                   | 100.0%                                   | 100.0%       |
| Cost of sales                                       | 74.4                                     | 86.6                                     | 81.6         | 82.4                                     | 87.6                                     | 84.7         | 79.1                                     | 91.9                                     | 84.5         |
| Gross profit  | 25.6                                     | 13.4                                     | 18.4         | 17.6                                     | 12.4                                     | 15.3         | 20.9                                     | 8.1                                      | 15.5         |
| Selling, general and administrative expenses        | 18.4                                     | 10.3                                     | 13.6         | 16.3                                     | 12.6                                     | 14.6         | 22.5                                     | 14.2                                     | 19.0         |
| Other income, net                                   | 4.0                                      | (0.6)                                    | 1.3          | 0.5                                      | (0.8)                                    | (0.1)        | 9.0                                      | 1.0                                      | 5.6          |
| Operating income                                    | 11.2                                     | 2.5                                      | 6.1          | 1.8                                      | (1.0)                                    | 0.6          | 7.4                                      | (5.1)                                    | 2.1          |
| Interest expense                                    |  |  |              |  |  |              |  |  |              |
| Non-operating income, net                           | 0.8                                      | 0.1                                      | 0.4          | 0.3                                      | (0.1)                                    | 0.1          | 0.5                                      | 0.6                                      | 0.6          |
| Income before income taxes                          | 12.0                                     | 2.6                                      | 6.5          | 2.1                                      | (1.1)                                    | 0.7          | 7.9                                      | (4.5)                                    | 2.7          |
| Income taxes  | 0.5                                      | (0.2)                                    | 0.1          | (0.1)                                    | (0.4)                                    | (0.2)        | 0.6                                      | 1.1                                      | 0.9          |
| Net income  | 11.5                                     | 2.8                                      | 6.4          | 2.2                                      | (0.7)                                    | 0.9          | 7.3                                      | (5.6)                                    | 1.8          |
| Net income attributable to non-controlling interest |  | 0.3                                      | 0.2          |  |  |              |  |  |              |

Net income  
attributable to  
Deswell

|                  |       |      |      |      |        |      |      |        |      |
|------------------|-------|------|------|------|--------|------|------|--------|------|
| Industries, Inc. | 11.5% | 2.5% | 6.2% | 2.2% | (0.7)% | 0.9% | 7.3% | (5.6)% | 1.8% |
|------------------|-------|------|------|------|--------|------|------|--------|------|

**Year ended March 31, 2010 Compared to Year Ended March 31, 2009**

*Net Sales* The Company's net sales for the year ended March 31, 2010 were \$81,614,000, a decrease of \$50,124,000 or 38.0% as compared to fiscal year 2009. The decrease was related to a decrease in sales revenue at our plastic segment of \$26,391,000 as well as \$23,733,000 at our electronic and metallic segment. This represented decreases of 36.0% and 40.7% respectively, as compared with the respective net sales from these segments in the prior fiscal year. The revenue decrease at the plastic segment was mainly due to the decrease in orders from existing customers of \$30,648,000 offsetting the increase in net sales from other existing and new customers of \$3,002,000 and \$1,255,000, respectively, as a result of the generally weak economy. About 83% of the decrease in net sales for the year ended March 31, 2010 was accounted for by one of the segment's major customers related to plastic component sales of electronic entertainment products. Net sales from this major customer for the year ended March 31, 2010 had dropped by about 59% due to a decrease in orders for one of their main products, as compared with the prior fiscal year.

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The revenue decrease in the electronic and metallic segment was mainly due to the decrease in orders of professional audio and electronics products from existing customers of \$24,470,000 and \$5,292,000, respectively, and a decrease in distributions sales of \$692,000, offsetting the increase in orders from existing and new customers for professional audio instrument products of \$6,721,000. The decrease in orders was due to the combined effect of the global economic downturn, persistent pressure of losing orders to lower-priced competitors, as well as change of customer mix.

Deswell's largest customer in both fiscal 2009 and 2010, N&J Company Ltd., reduced the volume of its orders during the year ended March 31, 2010 to 19.2% of Deswell's total sales from 28.6% of our total sales in fiscal 2009. Similarly, Digidesign, Inc. Deswell's largest customer in fiscal 2008, reduced the volume of its orders during the year ended March 31, 2009 to 12.7% of Deswell's total sales from 17.0% of its total sales in fiscal 2008. These reductions in sales of the Company's major customers contributed to the decreases in Deswell's total sales in fiscal 2009 from fiscal 2008 and in fiscal 2010 from fiscal 2009. This illustrates our dependence on a few major customers and that a substantial decrease in sales from any of our larger customers adversely impacts our sales and financial performance. See the discussion under "We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us. These risks have become particularly acute in the current adverse economic environment" in Item 3 Key Information Risk Factors, above.

**Gross Profit** The gross profit for the year ended March 31, 2010 was \$12,656,000, representing a gross profit margin of 15.5%. This compared with the overall gross profit and gross profit margin of \$20,168,000 or 15.3% for the year ended March 31, 2009.

Gross profit in the plastic segment decreased \$3,108,000 to \$9,844,000 or 20.9% of net sales for the year ended March 31, 2010, as compared to \$12,952,000 or 17.6% of net sales, for the same period in the prior year. Despite the reduction of gross profits, which resulted from a 36% decrease in sales during the year ended March 31, 2010, Deswell's gross profit margin percentage in the plastic segment increased by 3.3%. The improvement in gross profit margin as a percentage of sales in the plastic segment during the year ended March 31, 2010 primarily resulted from lower material costs as a percentage of sales stemming from a reduction of sales of lower profit margin items and from a 14% drop in the average costs of resin used in the manufacture of plastic products. These improvements were partially offset by higher factory overhead as a percentage of sales for the year ended March 31, 2010, when compared with fiscal 2009.

Gross profit in the electronic and metallic segment decreased by \$4,403,000 to \$2,813,000 or 8.1% of net sales, for the year ended March 31, 2010, as compared to \$7,216,000 or 12.4% of net sales, for last year. Decrease in the gross profit as a percentage of sales was mainly attributed to higher raw materials cost and factory overhead as a percentage of sales for the year ended March 31, 2010, when compared with fiscal 2009.

**Selling, general and administrative expenses** SG&A expenses for the year ended March 31, 2010 were \$15,505,000, amounting to 19.0% of total net sales, as compared to \$19,290,000 or 14.6% of total net sales for the year ended March 31, 2009. There was a decrease in selling, general and administrative expenses of \$3,785,000 or 19.6% over the corresponding period of last year.

The SG&A expenses for the year ended March 31, 2010 in the plastic segment decreased by \$1,381,000 to \$10,584,000 or 22.5% of net sales, as compared to \$11,965,000 or 16.3% of net sales for fiscal 2009. The decrease was primarily related to the decrease of \$442,000 in selling expenses, \$295,000 in director remuneration due to resignation of a co-founder during fiscal 2009, \$422,000 in traveling expenses and \$149,000 in equipment maintenance, offsetting an increase of \$175,000 in sundry expenses as compared with last fiscal year.

The SG&A expenses in the electronic and metallic segment decreased by \$2,405,000 to \$4,921,000 or 14.2% of net sales, for the year ended March 31, 2010, as compared to \$7,326,000 or 12.6% of net sales for fiscal 2009. The decrease was primarily related to the decreases of \$423,000 in selling expense, \$1,352,000 in staff costs related to a 30% reduction in headcount, \$322,000 in officers' remuneration due to the resignation of a co-founder of the electronic and metallic segment, \$108,000 in travelling expense and \$82,000 in office operating expense, as compared with the prior year.

*Other operating income* Other operating income was \$4,594,000 for the year ended March 31, 2010, as compared to other operating expense of \$132,000 in fiscal 2009.

On a segment basis, other operating income attributable to the plastic segment for the year ended March 31, 2010 was \$4,250,000, as compared to an operating income of \$348,000 for the prior fiscal year. The increase in other operating income for the year ended March 31, 2010 was mainly attributable to a net gain of \$4,198,000 that Deswell recognized from the sale of its former manufacturing plant in Shekou, Shenzhen, China, as compared to an

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exchange gain of \$901,000, a provision for doubtful receivables of \$275,000 and a loss incurred on a sale of fixed assets of \$236,000 in the prior year.

Other operating income attributable to the electronic and metallic segment for the year ended March 31, 2010 was \$344,000, as compared to other operating expense of \$480,000 in prior year. Fiscal 2010 other operating income was attributable to an exchange gain of \$44,000, a gain of \$156,000 on sales of scrap materials and \$113,000 in other income for the year ended March 31, 2010, as compared to \$196,000 in exchange loss and a provision of other receivables of \$437,000 for fiscal 2009.

*Operating Income* Operating income was \$1,745,000 for the year ended March 31, 2010, as compared with the operating income of \$745,000 in the prior fiscal year.

On a segment basis, operating income in the plastic division was \$3,509,000, or 7.4% of net sales in the year ended March 31, 2010 compared to operating income of \$1,335,000 or 1.8% of net sales in fiscal 2009. The increase in operating income in the plastic segment was mainly the result of an increase in other operating income offsetting the decrease in sales revenue and an increase in SG&A expenses as a percentage of sales, as discussed above.

The operating loss of the electronic and metallic segment was \$1,764,000, or a negative 5.1% of net sales in that segment in the year ended March 31, 2010 compared to operating loss of \$590,000 or a negative of 1.0% of net sales in fiscal 2009. The increase in operating loss for the electronic and metallic segment primarily resulted from a decrease in sales revenue and correspondingly lower gross profit amount, as discussed above.

*Non-operating income* Non-operating income for the year ended March 31, 2010 increased by \$276,000, to \$444,000, as compared with fiscal 2009. This increase was mainly attributable to interest income of \$166,000, an unrealized gain on the revaluation of marketable securities of \$39,000 in the plastic segment, and as a realized gain of \$160,000 from the sale of marketable securities in the electronic and metallic segment.

*Income Taxes* Income tax for the year ended March 31, 2010 was comprised of an income tax expense of \$380,000 and a deferred tax provision of \$310,000, which compares to an income tax expense of \$234,000 and a deferred tax benefit of \$516,000 for the fiscal 2009.

On a segment basis, income tax of the plastic segment was comprised of income tax expense of \$379,000 and a deferred tax benefit of \$91,000 for the year ended March 31, 2010, as compared to the income tax expense of \$207,000 and a deferred tax benefit of \$275,000 in fiscal 2009. The plastic segment's year-to-date income tax expense of \$379,000 was incurred and payable by one of the Company's subsidiaries. Such income tax was charged on the subsidiary's current taxable profit, after recognizing the gain on the sale of its former manufacturing plant in the second fiscal quarter of 2010 net of the subsidiary's accumulated tax loss carryforward from fiscal 2009.

The income tax expense and deferred tax provision for the electronic and metallic segment was \$1,000 and \$401,000, respectively for year ended March 31, 2010, as compared to the income tax expense of \$27,000 and a deferred tax benefit of \$241,000 for fiscal 2009.

*Net Income* The Company had net income of \$1,499,000 for the year ended March 31, 2010, an increase of \$304,000, as compared to net income of \$1,195,000 for the year ended March 31, 2009. Net income for the year ended March 31, 2010 represented 1.8% of net sales, compared to 0.9% of net sales for the net income in prior year. The increase in net income resulted primarily from the gain on the sale of the Company's former manufacturing plant in Shekou, Shenzhen, China, as discussed above.

Net income for the plastic segment for the year ended March 31, 2010 totaled \$3,446,000, as compared to the net income of \$1,620,000 for fiscal year 2009. The increase in net income of the plastic segment was mainly the result of an increase in other operating income offsetting a decrease in gross profit, as described above.

Net loss for the electronic and metallic segment for the year ended March 31, 2010 was \$1,947,000, compared to the net loss of \$425,000 for the prior fiscal year. The decrease in net loss of the electronic and metallic segment was mainly the result of decrease in sales revenue and correspondingly lower gross profit amount as described above.

**Year ended March 31, 2009 Compared to Year Ended March 31, 2008**

*Net Sales* The Company's net sales for the year ended March 31, 2009 were \$131,738,000, a decrease of \$12,068,000 or 8.4% as compared to the year ended March 31, 2008. Sales to N&J Company Limited and Digidesign Inc., the Company's two largest customers during the year ended March 31, 2009, represented approximately 41.3% of net sales for the year. See Item 4. Information on the Company's Major Customers, above. The decrease was related to

a decrease in sales revenue at our electronic and metallic segment of \$26,637,000

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offsetting the increase in sales at our plastic segment of \$14,569,000. This represented a decrease of 31.3% and an increase of 24.8% respectively, as compared with the respective net sales from these segments in fiscal 2008.

The revenue increase at the plastic segment was mainly due to the increase in orders from existing and new customers of \$23,321,000 offsetting the decrease in orders from other existing customers of \$8,751,000. The increase was principally due to a \$20,671,000 increase in plastic component sales of electronic entertainment products. The increase in orders in our plastic segment was largely from N&J, one of our major customers during both fiscal 2008 and 2009, which accounted for 28.6% of our total net sales during the year ended March 31, 2009, up from 11.8% of our total net sales during the year ended March 31, 2008.

The revenue decrease in the electronic and metallic segment was mainly due to the decrease in orders of electronics and metallic products from existing customers of \$35,175,000 and \$2,075,000, respectively, offsetting the increase in orders from existing and new customers for professional audio instrument products of \$10,651,000. The increase in total orders for professional audio instrument products largely came from existing customers other than Digidesign. The overall decrease in orders of electronics and metallic products from existing customers was due to the combined factors of a decline in demand as a result of the global economic recession, persistent pressure of losing orders to competitors which provide lower-priced products, and a change in product mix from low-end to high-end products. We believe that these factors resulted in the reduction in orders from Digidesign, down to 12.7% of our total net sales the year ended March 31, 2009, from 17.0% of our total net sales during 2008, and the decline in orders from each of Line 6 Manufacturing ( Line 6 ) and Inter-Tel Incorporated ( Inter-Tel ) to below 10% of our total net sales during the year ended March 31, 2009. Line 6 and Inter-Tel accounted for 14.3% and 10.2%, respectively, of our total net sales during the year ended March 31, 2008. These declines in net sales to Digidesign, Line 6 and Inter-Tel during the year ended March 31, 2009 illustrates our dependence on a few major customers and that substantial decreases in sales from any of our larger customers adversely impacts our sales and financial performance. See the discussion under We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us. These risks have become particularly acute in the current adverse economic environment in Item 3 Key Information Risk Factors, above.

*Gross Profit* Our gross profit for the year ended March 31, 2009 was \$20,168,000, representing a gross profit margin of 15.3%. This compared with the overall gross profit and gross profit margin of \$26,433,000 or 18.4%, respectively, for the year ended March 31, 2008.

Gross profit in the plastic segment decreased by \$2,118,000 to \$12,952,000, or 17.6% of net sales, for the year ended March 31, 2009, as compared to \$15,070,000, or 25.6% of net sales, for the year ended March 31, 2008. The decrease in gross margin for the plastic segment was mainly due to the shift of product mix to lower margin products, as compared with the prior year. The decrease in gross margin was also driven by higher material costs as a result of a 10% rise in resin price and an approximate 9.05% appreciation of RMB, plus an increase in labor costs caused by a 17% rise in labor rates in spite of headcount reductions, when compared to fiscal 2008.

Gross profit in the electronic and metallic segment decreased by \$4,147,000 to \$7,216,000, or 12.4% of net sales, for the year ended March 31, 2009 compared to \$11,363,000, or 13.4% of net sales, for the year ended March 31, 2008. The decrease in gross margin was primarily attributable to relatively higher labor cost caused by a 28.4% increase in labor rates despite headcount reductions throughout the year together with a general decline in sales demand in the year ended March 31, 2009, as compared with last year.

*Selling, general and administrative expenses* SG&A expenses for the year ended March 31, 2009 were \$19,291,000, amounting to 14.6% of total net sales, as compared to \$19,601,000 or 13.6% of total net sales for the year ended March 31, 2009. There was a decrease in selling, general and administrative expenses of \$310,000 or 1.6% over the corresponding period.

The SG&A expenses in the plastic segment increased by \$1,142,000 to \$11,965,000, or 16.3% of net sales, for the year ended March 31, 2009 compared to \$10,823,000, or 18.4% of net sales, for the year ended March 31, 2008. The increase in the SG&A expenses was primarily related to the increase in salaries and bonuses of \$516,000 as a result of 17.3% increase in pay rates, and \$132,000 in social insurance, and \$100,000 in value-added taxes and property taxes, as compared with the year ended March 31, 2008.



The SG&A expenses in the electronic and metallic segment decreased by \$1,452,000 to \$7,326,000 or 12.6% of net sales, for the year ended March 31, 2009 compared to \$8,778,000 or 10.3% of net sales for the prior year. The decrease was primarily due to the continued cost control measures resulting in a decrease of \$612,000 in salaries and bonuses, \$410,000 in social insurance and staff welfare expenses, \$80,000 in travelling expenses and \$52,000 in rental expenses as compared with the corresponding period in the prior year. There was also a decrease

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of \$73,000 in selling expense as well as \$65,000 in depreciation expense when compared to the year ended March 31, 2008.

*Other operating income* Other operating expense was \$132,000 for the year ended March 31, 2009, representing a decrease of \$1,970,000 as compared with last year.

On a segment basis, other operating income attributable to our plastic segment for the year ended March 31, 2009 was \$348,000, a decrease of \$1,996,000 as compared with the prior year. The decrease was principally the result of a lower revaluation of monetary assets by \$1,370,000 due to a less volatile exchange rate of United States Dollar to the RMB. The decrease in other operating income was also attributable to an additional provision for doubtful debt of \$258,000, asset impairment for \$176,000 and loss on disposal of fixed assets of \$134,000 during the year ended March 31, 2009.

Other operating expense attributable to our electronic and metallic segment for the year ended March 31, 2009 was \$480,000, as compared to the other operating expense of \$508,000 in fiscal 2008. The decrease was primarily the result of no impairment on the goodwill relating to the metallic division during fiscal 2009 as compared to \$318,000 impairment loss recognized during fiscal 2008. During fiscal 2009, there was also a decrease in foreign exchange loss by \$176,000, partially offsetting a provision of other receivables of \$437,000, as compared to fiscal 2008.

*Operating Income* Operating income was \$745,000 for the year ended March 31, 2009, as compared with the operating income of \$8,670,000 from the corresponding year in the prior year.

On a segment basis, operating income of the plastic division was \$1,335,000, or 1.8% of net sales, in the year ended March 31, 2009, as compared to operating income of \$6,593,000, or 11.2% of net sales, for the year ended March 31, 2008. Operating income in the plastic division decreased primarily from the decrease in gross margin as a result of higher material usage and cost, factory overhead, and the decrease in other operating income as described above.

The operating loss of the electronic & metallic segment was \$589,000, or 1.0% of net sales, in the year ended March 31, 2009, compared to operating income of \$2,077,000, or 2.4% of net sales, in fiscal 2008. Electronic & metallic operating income decreased due to the decrease in sales revenue and gross margin as well as a relative increase in SG&A expenses as a percentage of sales as described above.

*Non-operating income* Non-operating income for the year ended March 31, 2009 decreased by \$353,000 to \$168,000, as compared with fiscal 2008. This is mainly attributable to the decrease in interest income of \$38,000 and an unrealized gain on the revaluation of marketable securities of \$25,000 in the electronic and metallic segment, as well as the decrease in interest income of \$243,000 in the plastic division during fiscal 2009.

*Income Taxes* Income taxes for the year ended March 31, 2009 were comprised of income tax expenses of \$234,000 and a deferred tax benefit of \$516,000, as compared with the income tax expenses of \$654,000 and a deferred tax benefit of \$550,000 fiscal 2008.

*Non-controlling Interest* There was no non-controlling interest for the year ended March 31, 2009. In August 2007, the Company acquired the remaining 24% non-controlling interest in Integrated International Limited, the holding company holding the capital stock of Deswell's electronic and metallic subsidiaries, thereby increasing Deswell's interest in that company from 76% to 100%. As a result, the dollar amount of non-controlling interest decreased to zero for the year ended in March 31, 2009 from \$228,000 for fiscal 2008.

*Net Income* The Company reported net income of \$1,195,000 for the year ended March 31, 2009, a decrease of \$7,664,000, as compared to a net income of \$8,859,000 for the year ended March 31, 2008. Net income for the year ended March 31, 2009 represented 0.9% of net sales, compared to 6.2% of net sales for the net income the prior year. The decrease in net income was mainly the result of the decrease in sales revenue, gross profit margin, and other operating income as described above.

Net income for the plastic segment for the year ended March 31, 2009 totaled \$1,620,000, as compared to net income of \$6,735,000 for the prior year. The decrease in net income of the plastic segment was primarily the result of lower gross profit margin and the decrease in other operating income as described above.

Net loss for the electronic and metallic segment for the year ended March 31, 2009 was \$425,000, compared to net income of \$2,124,000 for the prior year. The decrease in net income of the electronic and metallic segment was principally the result of the decrease in sales revenue, lower gross profit margin, and relatively higher SG&A expenses

as a percentage of sales as described above.

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The following table sets forth certain unaudited quarterly financial information sequentially for the twelve quarters in the three-year period ended March 31, 2010 (in thousands):

|                         | Year ended March 31, |          |          |          |          |          |          |          |          |          |          |          |
|-------------------------|----------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
|                         | 2008                 |          |          |          | 2009     |          |          |          | 2010     |          |          |          |
|                         | Q1                   | Q2       | Q3       | Q4       | Q1       | Q2       | Q3       | Q4       | Q1       | Q2       | Q3       | Q4       |
| Net sales               | \$38,452             | \$38,414 | \$35,416 | \$31,524 | \$35,039 | \$32,241 | \$37,101 | \$27,357 | \$22,738 | \$20,852 | \$21,358 | \$16,666 |
| Gross profit            | 6,762                | 6,698    | 7,923    | 5,050    | 5,901    | 3,524    | 6,413    | 4,330    | 3,603    | 2,907    | 4,049    | 2,097    |
| Operating income (loss) | 3,304                | 1,681    | 3,033    | 652      | 1,310    | (1,663)  | 878      | 220      | (272)    | 2,938    | 296      | (1,218)  |
| Net income (loss)       | 3,111                | 1,755    | 2,955    | 1,038    | 1,293    | (1,675)  | 987      | 590      | (253)    | 3,124    | (437)    | (935)    |

The following table sets forth the same unaudited quarterly information presented in the above table but by quarterly comparisons by year in the three-year period ended March 31, 2010 (in thousands):

|                         | Three months ended |          |          |              |          |          |             |          |          |          |          |          |
|-------------------------|--------------------|----------|----------|--------------|----------|----------|-------------|----------|----------|----------|----------|----------|
|                         | June 30,           |          |          | September 30 |          |          | December 31 |          |          | March 31 |          |          |
|                         | 2008               | 2009     | 2010     | 2008         | 2009     | 2010     | 2008        | 2009     | 2010     | 2008     | 2009     | 2010     |
| Net sales               | \$38,452           | \$35,039 | \$22,738 | \$38,414     | \$32,241 | \$20,852 | \$35,416    | \$37,101 | \$21,358 | \$31,524 | \$27,357 | \$16,666 |
| Gross profit            | 6,762              | 5,901    | 3,603    | 6,698        | 3,524    | 2,907    | 7,923       | 6,413    | 4,049    | 5,050    | 4,330    | 2,097    |
| Operating income (loss) | 3,304              | 1,310    | (272)    | 1,681        | (1,663)  | 2,938    | 3,033       | 878      | 296      | 652      | 220      | (1,218)  |
| Net income (loss)       | 3,111              | 1,293    | (253)    | 1,755        | (1,675)  | 3,124    | 2,955       | 987      | (437)    | 1,038    | 590      | (935)    |

The first calendar quarter (the fourth fiscal quarter ending March 31 of our fiscal year) is typically the Company's slowest sales period because, as is customary in China, the Company's manufacturing facilities in China are closed for two weeks for the Chinese New Year holidays. The Company does not experience any other significant seasonal fluctuations.

**Impact of Inflation**

The Company believes that inflation has not had a material effect on its business. Although the Company has found it difficult to increase the prices of its products in order to keep pace with inflation, particularly in its plastics operations, the Company believes that the location of its manufacturing operations in Southern China has resulted in a lower cost base which still provides it with a competitive advantage. Accordingly, the Company is reliant upon increasing its transaction volume in order to compensate for the effects of inflation.

**Exchange Rates**

The Company's sales are mainly in United States dollars and Hong Kong dollars and its expenses are mainly in United States dollars, Hong Kong dollars and Chinese RMB.

The Hong Kong dollar has been pegged to the U.S. dollar at approximately 7.80 and relatively stable. The exchange rates between the Hong Kong dollars and the U.S. dollar were approximately 7.782, 7.7597 and 7.764 at March 31, 2008, 2009 and 2010, respectively. The Hong Kong government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar and has not in the past presented a material currency exchange risk. Although announcements by Hong Kong's central

bank indicate its intention to maintain the currency peg between the Hong Kong dollar and the U.S. dollar, if Hong Kong does change and follows China to a floating currency system or otherwise changes the exchange rate system of Hong Kong dollars to the U.S. dollars, our margins and financial results could be adversely affected.

Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People's Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11. The following chart illustrates the fluctuations of the RMB to the US dollar from July 21, 2005 by showing, on a calendar and Deswell-fiscal year basis, the exchange ratio at the end of each quarter after July 21, 2005, the date of the RMB to US dollar adjustment to March 31, 2010.

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(1) RMB (yuan) to US dollar data presented in this chart were derived from the historical currency converter available at <http://forex-history.net>.

(2) If the end of a quarter fell on a Saturday or Sunday, datum is provided as of the previous Friday

Approximately 48.7%, 35.1% and 51.0% of our total costs and expenses were in RMB during the years ended March 31, 2008, 2009 and 2010, respectively.

In our fiscal years following the July 21, 2005 adjustment in the exchange ratio, the exchange ratio of the RMB to the US dollar has appreciated each year through March 31, 2010, albeit to a substantially lesser degree beginning in mid-2008. The following table shows the percentage appreciation.

| <b>Exchange ratio of RMB to US\$1.00 at March 31,</b> |                               |              |                               |              |                               |              |                               |              |                               |
|---|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|--------------|-------------------------------|
| <b>2006</b>   |                               | <b>2007</b>  |                               | <b>2008</b>  |                               | <b>2009</b>  |                               | <b>2010</b>  |                               |
| <b>Ratio</b>  | <b>% change<sup>(1)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> | <b>Ratio</b> | <b>% change<sup>(2)</sup></b> |
| 1:8.017   | 1.16%                         | 1:7.730      | 3.58%                         | 1:7.012      | 9.29%                         | 1:6.834      | 2.54%                         | 1:6.826      | 0.11%                         |

(1) From ratio at July 22, 2005.

(2) From ratio at preceding March 31.

In mid-2008, the Chinese government halted allowing the RMB to appreciate against the dollar as it did during earlier periods since July 25, 2005 because of concerns that the stronger RMB was hurting Chinese exports at a time of global recession. Accordingly, as shown in the above table, there was virtually no change in the exchange ratio of the RMB to the US dollar during our year ended March 31, 2010. However, on June 19, 2010 China's central bank announced that it planned to introduce more flexibility in the management of its currency and since then the RMB has again begun to appreciate against the US dollar, increasing approximately 0.7% from, according to the historical currency converter available at <http://forex-history.net>, RMB 6.8262 on June 18, 2010 to RMB 6.78 on July 22, 2010.

We did not hedge our currency risk during the years ended March 31, 2008, 2009 and 2010 and at March 31, 2010, we had no open forward currency contracts. We continually review our hedging strategy and there can be no assurance that hedging techniques we may implement will be successful or will not result in charges to our results of operations.

**Table of Contents****2009 Change in Functional Currency**

Prior to January 1, 2009, the functional currencies of our subsidiaries were Hong Kong dollars and Chinese renminbi, or RMB. Effective January 1, 2009, the functional currencies of all our subsidiaries were changed to U.S. dollars. The U.S. dollar is considered by management to be the most appropriate functional currency of Deswell's subsidiaries because over the years, and especially in our year ended March 31, 2009 and continuing in our year ended March 31, 2010, most of our customers contracted with our subsidiaries in U.S. dollars. The following table shows the percent of our sales that were denominated in US dollars for the years ended March 31, 2008, 2009 and 2010:

|                                      | Year ended March 31, 2008         |                               |       | Year ended March 31, 2009         |                               |       | Year ended March 31, 2010         |                               |       |
|--------------------------------------|-----------------------------------|-------------------------------|-------|-----------------------------------|-------------------------------|-------|-----------------------------------|-------------------------------|-------|
|                                      | Plastic Injection Molding Segment | Electronic & Metallic Segment | Total | Plastic Injection Molding Segment | Electronic & Metallic Segment | Total | Plastic Injection Molding Segment | Electronic & Metallic Segment | Total |
| Percent of sales denominated in US\$ | 54.5%                             | 96.0%                         | 79.5% | 72.4%                             | 95.0%                         | 82.3% | 62.7%                             | 95.0%                         | 76.2% |

Primarily because of the stability of the exchange rate between the Hong Kong dollar and the U.S. dollar, which has existed since the Hong Kong government pegged the exchange rate at HK\$7.80 to US\$1.00 in 1983, and, to a lesser degree, because of the relative stability in the exchange rate of the RMB to the U.S. dollar since mid-2008 when the Chinese government halted allowing the RMB to appreciate against the dollar, the actual effect of the change in our functional currency to the U.S. dollar was immaterial to our results of operations, liquidity and cash flows for our years ended March 31, 2009 or March 31, 2010. We do not currently expect that it is reasonably likely that the change in our functional currency to the US dollar will have a material effect on our results of operations, liquidity or cash flows in future periods.

Irrespective of our functional currency, however, if the exchange rate of the RMB to US dollar again becomes volatile, our results of operations would be affected, positively or negatively, depending on the amounts of expenses our subsidiaries pay in RMB and whether the RMB depreciates or appreciates to the US dollar. As discussed under Exchange Rates above, the exchange rate of the RMB has been appreciating since June 19, 2010 when China's central bank announced that it planned to introduce more flexibility in the management of China's currency. If the RMB continues appreciating to the U.S. dollar, our operating costs would increase and our financial results would be adversely affected. See the Risk Factor entitled Changes in currency exchange rates have and could continue to significantly affect our financial results on page 11 of this Report.

**Liquidity and Capital Resources**

For the year ended March 31, 2010, net cash generated from operations totaled \$14,351,000, including net income of \$1,499,000 and depreciation and amortization of \$7,011,000. Accounts receivable decreased by \$7,828,000, over levels at March 31, 2009, primarily as a result of the decrease in total sales volume. Inventories decreased by \$5,637,000 over levels at March 31, 2009, primarily resulting from the decreases in raw materials and work-in-progress of plastic and electronics products. Accounts payable decreased by \$3,072,000 over levels at March 31, 2009, primarily because of the decrease in materials purchases. For the year ended March 31, 2009, net cash generated from operations totaled \$11,669,000, including net income of \$1,195,000 and depreciation and amortization of \$7,264,000.

Net cash used in investing activities amounted to \$1,449,000 and \$7,057,000 for the year ended March 31, 2010 and 2009, respectively. Capital expenditures during these periods totaled \$1,606,000 and \$7,402,000, respectively. Our capital expenditures were primarily related to the acquisition of property, plant and equipment for our two manufacturing plants in Dongguan, China. In fiscal 2010, we acquired marketable securities for \$5,631,000 and received proceeds of \$5,185,000, net of transaction costs, from the sale of our former manufacturing plant in Shekou, Shenzhen, China.

Net cash used in financing activities for the years ended March 31, 2010 and 2009 were \$916,000 and \$3,789,000, respectively. Net cash we used in financing activities during the year ended March 31, 2010 was primarily to fund

dividend payments to shareholders of \$1,619,000 and net of the proceeds of \$703,000 from the exercise of stock options from directors and employees. Net cash we used in financing activities during the year ended March 31, 2009 was primarily to fund the dividend payments to shareholders of \$3,789,000.

As a consequence of the fixed exchange rate between the Hong Kong dollar and the U.S. dollar, interest rates on Hong Kong dollar borrowings are similar to U.S. interest rates. The Hong Kong Prime Rate at March 31, 2010 remained at 5.0% from March 31, 2009.



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At March 31, 2010, the Company had cash and cash equivalents of \$35,120,000. At that date, Deswell had no committed credit facilities and no restricted cash. Deswell expects that working capital requirements and capital additions will continue to be funded through cash on hand and internally generated funds. However, Deswell may choose to seek to obtain additional debt or equity financing if it believes it to be appropriate and available on reasonable terms. The Company's working capital requirements are expected to increase in line with the growth in the Company's business.

At March 31, 2010, the Company had capital commitments for purchase of plant and machinery, leasehold improvements, totaling \$73,000 and \$20,000, respectively, which are expected to be disbursed during the year ending March 31, 2011. Also, the Company had capital commitments for a new enterprise resource planning software system upgrade project at March 31, 2010 totaling \$191,000, which we expect to disburse by March 31, 2011.

A summary of our contractual obligations and commercial commitments as of March 31, 2010 is as follows:

|  | <b>Total</b>   | <b>Payments due by period (in thousands)</b> |  |  |                                    |
|--|----------------|--|--|--|------------------------------------|
|  |                | <b>Year ending March 31, 2011</b>            | <b>Period from April 1, 2011 to March 31, 2013</b> | <b>Period from April 1, 2013 to March 31, 2015</b> | <b>Period after March 31, 2015</b> |
| Contractual obligations  |                |  |  |  |                                    |
| Long-term bank borrowing   | \$             |  |  |  |                                    |
| Capital (finance) lease obligations  |                |  |  |  |                                    |
| Operating lease payments   | 29             | 29   |  |  |                                    |
| Capital commitment   | 284            | 284  |  |  |                                    |
| Other purchase obligations   | 6,806          | 6,806  |  |  |                                    |
| Other long-term liabilities reflected on Company's balance sheet under US GAAP |                |  |  |  |                                    |
| <b>Total</b>   | <b>\$7,119</b> | <b>\$7,119</b>                               | <b>\$</b>  | <b>\$</b>  | <b>\$</b>                          |

**Off Balance Sheet Arrangements**

We do not use off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities.

**Critical Accounting Policies and Recent Changes in Accounting Standards**

For a discussion of critical accounting policies and recently issued and changes in accounting standards relevant to our financial performance and financial statements, see Note 2 of Notes to Consolidated Financial Statements included in Part III, Item 18, in this Report.

**Table of Contents****Item 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****Directors and Senior Management**

The directors and executive officers of the Company at June 30, 2010 are as follows:

| <b>Name</b>           | <b>Age</b> | <b>Position(s) with Company</b>  |
|-----------------------|------------|--|
| Richard Pui Hon Lau   | 65         | Chairman of the Board of Directors   |
| Franki Shing Fung Tse | 46         | Chief Executive Officer  |
| Chin Pang Li          | 64         | Executive Director of Manufacturing and Administration for Plastic Operations and Member of the Board of Directors |
| Hung-Hum Leung        | 64         | Non-Executive Director and Member of Audit Committee   |
| Allen Yau-Nam Cham    | 63         | Non-Executive Director and Chairman of Audit Committee   |
| Wing-Ki Hui           | 64         | Non-Executive Director and Member of Audit Committee   |
| Betty Ching Han Lam   | 48         | Chief Financial Officer  |

Richard Pui Hon Lau. Mr. Lau served as Chief Executive Officer and Chairman of the Board of Directors of the Company and its predecessors since their inception in 1987 until February 2007, at which time he retired as Chief Executive Officer. Mr. Lau remains as Chairman of the Board.

Franki Shing Fung Tse. Mr. Tse joined Deswell in February 2007 at its Chief Executive Officer, bringing with him over 19 years' experience in the tool-making, plastic injection and electronic service provider, or EPS, industry. From July 2005 until joining Deswell, he served as Vice President of Operations for Goodbaby Child Products Co. Ltd., a leading baby-products manufacturing company in Shanghai, China with approximately 15,000 workers. From May 2001 to June 2005 Mr. Tse served as Director of Marketing of Deswell's plastic subsidiary, Jetcrown Industrial (Dongguan) Ltd. From 1988 to 2000, Mr. Tse was in charge of the China Sales Business Division of Qualidux Industrial Co., Ltd., a group of companies engaged in original design and original equipment plastics manufacturing. Mr. Tse received his MBA in Business Finance from the University of Lincoln, United Kingdom in 2002.

Chin Pang Li. Mr. Li has served the Company as a Member of the Board of Directors and in various executive capacities with the Company and its predecessors since their inception in 1987. He became Secretary of the Company in February 1995 and Chief Financial Officer in May 1995, a position which he held until March 31, 2006. As Executive Director of Manufacturing and Administration for Plastic Operations, Mr. Li is in charge of the manufacturing and administrative operations for the Company's plastic products. Mr. Li received his Bachelor of Science degree from Chun Yan Institute College, Taiwan in 1967.

Hung-Hum Leung. Mr. Leung has been a non-executive director of the Company and member of the Audit Committee since December 1999. Mr. Leung has over 25 years of experience in the manufacture of electronic products. Mr. Leung was the founder of Sharp Brave Holdings Ltd., a Hong Kong public company listed on the Hong Kong Stock Exchange, and from 1991 to 1995 served as the Chairman of Sharp Brave Holdings Ltd. Since 1995, Mr. Leung has been an independent consultant to the electronics industry. He received his Bachelor of Science degree in Physics from the National Taiwan University in 1971.

Allen Yau-Nam Cham. Mr. Cham has been a non-executive director of the Company and member of the Audit Committee since August 2003. Mr. Cham has been the Managing Director and shareholder of Kwong Fat Hong (Securities) Limited since 1995. He has over 20 years of experience in the securities industry. He is a Certified General Accountant in Canada. He obtained his Bachelor of Science degree from St. Mary's University, Halifax, Canada, Bachelor of Engineering (Electrical) degree from Nova Scotia Technical College, Halifax, Canada and Master of Business Administration degree from University of British Columbia, Canada.

Wing-Ki Hui. Mr. Hui has been a non-executive director of the Company and member of the Audit Committee since October 2004. Since 1995 he has been the Operation Director of Tomorrow International Holdings Limited, a company listed on the Hong Kong Stock Exchange engaged in manufacturing of consumer electronics and printed circuit boards. Prior to serving in this capacity, Mr. Hui was Executive Director of Sharp Brave International Holdings Limited from 1991 to 1995 and Director of Sharp Brave Electronics Co., Ltd. from 1984 to 1995. Mr. Hui possesses over 20 years of experience in the electronic manufacturing industry, and is a graduate of South East Electronic College in Hong Kong.

Betty Ching Han Lam. Ms. Lam joined the Company as Chief Financial Officer effective on August 1, 2008. Ms. Lam has over 20 years experience in accountancy profession in various industries. Before joining Deswell, Ms. Lam served as Finance Director from August 2007 until July 2008, and as Financial Controller from March 2000 to July 2007, for Paxar (China) Limited, a multinational corporation manufacturing packaging items, hang tags, woven and paper labels for the garment industries. During the fifteen years preceding her tenure at Paxar,

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Ms. Lam served in the finance departments of other enterprises, including over three years with Deloitte Haskins & Sells, an international public accounting firm that was one of the predecessors of Deloitte & Touche (Deloitte, Touche Tohmatsu in Asia). Ms. Lam received her Master of Business in Accounting and Finance from the University of Technology, Sydney in 1996 and her Professional Diploma in Accountancy from the Hong Kong Polytechnic in 1985.

No family relationship exists among any of the named directors, executive officers or key employees. No arrangement or understanding exists between any director or officer and any other persons pursuant to which any director or executive officer was elected as a director or executive officer of the Company.

### **Compensation of Directors and Executive Officers**

#### *Executive Officers*

The aggregate amount of compensation (including non-cash benefits) paid by the Company and its subsidiaries during the year ended March 31, 2010 to all directors and executive officers as a group for services in all service capacities was approximately \$1,217,000 which

excludes amounts paid by the Company or its subsidiaries as dividends to directors and executive officers in their capacity as shareholders of the Company during the year ended March 31, 2010; and

includes compensation amounts paid to an executive who left the Company during the year ended March 31, 2010.

See the discussion under "We depend on our executive officers, senior managers and skilled personnel." in Item 3 Key Information "Risk Factors" on page 14 of this Report.

#### *Directors*

Effective August 1, 2003, directors who are not employees of the Company or any of its subsidiaries are paid \$2,000 per month for services as a director, and are reimbursed for all reasonable expenses incurred in connection with services as a director and member of Board committees. The Board has determined that Messrs. Hung-Hum Leung, Allen Yau-Nam Cham and Wing-Ki Hui are each independent within the meaning of Rule 5605(a) (2) of the NASDAQ Marketplace Rules.

### **Board Practices**

The directors of the Company are elected at its annual meeting of shareholders and serve until their successors take office or until their death, resignation or removal. The executive officers serve at the pleasure of the Board of Directors of the Company.

### **Audit Committee**

The Audit Committee meets from time to time to review the financial statements and matters relating to the audit and has full access to management and the Company's auditors in this regard. The Audit Committee recommends the engagement or discharge of the Company's independent accountants, consults on the adequacy of the Company's internal controls and accounting procedures and reviews and approves financial statements and reports. Deswell's audit committee consists of Messrs. Hung-Hum Leung, Allen Yau-Nam Cham and Wing-Ki Hui, each of whom is an independent director within the meaning of that term under Rule 5605(a)(2) of the NASDAQ Marketplace Rules. Mr. Allen Yau-Nam Cham currently acts as the Chairman of the Audit Committee.

### **Other Committees; NASDAQ Compliance**

In August 2005, Deswell determined to disband and no longer have either a compensation committee or a nominating committee as the law of the British Virgin Islands, Deswell's place of organization, and Deswell's Memorandum and Articles of Association do not require it to have such committees. Moreover, the law of the British Virgin Islands does not require that the compensation of our Chief Executive Officer and other executive officers to be determined or recommended to the board by a majority of our independent directors or require that nominees for appointment as our directors be selected or recommended by a majority of our independent directors. Although such board practices or committees, consisting of independent directors as defined by NASDAQ's Marketplace Rules, are required of U.S. domestic public companies with securities listed on The Nasdaq Stock Market, they are not required of foreign private issuers such as Deswell if such issuers follow their home country practice. In addition to not having a compensation committee or a nominating committee consisting of independent directors, Deswell also follows home country practice of not having nominees to its board selected or recommended by a majority of its independent

directors; not having the compensation of its Chief Executive Officer and other

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executive officers determined or recommended to the board by a majority of our independent directors; and Deswell's independent directors do not meet in executive session.

Until the retirement of Chi Wai Leung effective January 1, 2009, who, in addition to serving as our Executive Director of Engineering for Plastic Operations, also served on our board of directors, a majority of our Board of Directors were not independent directors within the definition of independent director in NASDAQ Marketplace Rule 4200(a)(15) (which was in effect at the time of such resignation and has since been replaced without material change by NASDAQ Marketplace Rule 5605(a)(2)) and accordingly we did not theretofore comply with then applicable NASDAQ Marketplace Rule 4350(c)(1). Although our Board now consists of a majority of independent directors, if we choose to fill Mr. Leung's former position on our Board with a member of our management team or a person not otherwise deemed independent under NASDAQ's Marketplace Rules, we would not then comply with NASDAQ Marketplace Rule 5605(b)(1) (which replaced NASDAQ Marketplace Rule 4350(c)(1) effective April 13, 2009) and our corporate governance standards would again differ in this regard from those applied to US domestic issuers under NASDAQ's Marketplace Rules. See also Our exemptions from certain of the reporting requirements under the Exchange Act limits the protections and information afforded to investors on page 16 in the Risk Factors section of this Report for a further discussion of how our SEC reporting and corporate governance practices differ from those applicable to US domestic issuers and US NASDAQ-listed companies.

**Employees**

At March 31, 2010, the Company employed 3,474 persons on a full-time basis, of which nine were located in Macao and 3,465 were located in or travel to and from China. Of the Company's employees, at March 31, 2010 2,586 engaged in plastic injection molding manufacturing, and

888 engaged in contract electronic manufacturing, metal molds and parts manufacturing.

The Company has not experienced significant labor stoppages. Management believes that relations with the Company's employees are satisfactory.

**Share and Option Ownership of Directors and Senior Management**

For information concerning the beneficial ownership of the Company's common shares, including options, by directors and senior management and major shareholders, see Item 7 of this Report.

**Employee Stock Option Plans**

In 1995, the Company adopted its 1995 Stock Option Plan permitting the Company to grant options to purchase up to 1,012,500 common shares to employees, officers, directors and consultants of the Company. On September 29, 1997, the Company's Board of Directors and shareholders approved an increase of 549,000 shares in the number of shares that can be optioned and sold under the Option Plan bringing to a total of 1,561,500 shares the number of common shares that can be optioned and sold under the 1995 Stock Option Plan. No shares remain available for grant under the Company's 1995 Stock Option Plan.

On August 15, 2001 the Board approved the adoption of the 2001 Stock Option Plan permitting the Company to grant options to purchase up to an additional 1,125,000 common shares to employees, officers, directors and consultants of the Company. On January 7, 2002 shareholders approved the 2001 plan.

On August 20, 2003, the Board approved the adoption of the 2003 Stock Option Plan permitting the Company to grant options to purchase up to an additional 900,000 common shares to employees, officers, directors, consultants and advisors of the Company. On September 30, 2003 shareholders approved the 2003 plan. On August 1, 2005, the Company's Board of Directors, subject to shareholder approval, approved amendments to the 2003 Stock Option to increase by 500,000 shares in the number of shares that can be optioned and sold under the 2003 Stock Option Plan, bringing to a total of 1,400,000 shares the number of common shares that can be optioned and sold under the 2003 Stock Option Plan. The Company's shareholders approved this amendment at the Company's Annual Shareholders Meeting held on September 19, 2005.

On August 17, 2007, the Company's Board of Directors, subject to shareholder approval, approved amendments to the 2003 Stock Option to increase by 400,000 shares in the number of shares that can be optioned and sold under the 2003 Stock Option Plan, bringing to a total of 1,800,000 shares the number of common shares that can be optioned and sold under the 2003 Stock Option Plan. The Company's shareholders approved this amendment at the Company's

Annual Shareholders Meeting held on October 9, 2007.

The Company's option plans are administered by the Board of Directors, which determines the terms of options granted, including the exercise price, the number of shares subject to the option and the option's exercisability. The exercise price of all options granted under the option plans must be at least equal to the fair

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market value of such shares on the date of grant. The maximum term of options granted under the option plans is 10 years.

At June 30, 2010 :

options to purchase an aggregate of 4,269,000 shares had been granted under all of Deswell's option plans,

there were options to purchase an aggregate of 690,500 common shares outstanding, and

there were options to purchase 217,500 shares available for future grant under Deswell's option plans.

**Item 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****Major Shareholders**

The Company is not directly owned or controlled by another corporation or by any foreign government. The following table sets forth, as of June 30, 2010, the beneficial ownership of the Company's common shares by each person known by the Company to beneficially own 5% or more of the common shares of the Company and by each of the Directors and Senior Management of the Company who beneficially own in excess of one percent of the Company's common shares.

| <b>Name of beneficial owner or identity of group</b> | <b>Number of shares beneficially owned<sup>(1)</sup></b> |                |
|--|--|----------------|
|  | <b>Amount</b>  | <b>Percent</b> |
| Richard Pui Hon Lau                                  | 1,716,045 <sup>(2)</sup>                                 | 10.4           |
| Chin Pang Li   | 1,520,750 <sup>(3)</sup>                                 | 9.2            |
| FMR LLC and Edward C. Johnson 3d                     | 991,999 <sup>(4)</sup>                                   | 6.1            |
| Franki Shing Fung Tse                                | *  | *              |
| Betty Ching Han Lam                                  | *  | *              |
| Hung-Hum Leung                                       |  |                |
| Allen Yau-Nam Cham                                   |  |                |
| Wing-Ki Hui  |  |                |

\* Less than 1%.

(1) Based on 16,191,810 shares outstanding on June 30, 2010. However, in accordance with Rule 13d-3(d) (1) under the Securities Exchange Act of 1934, shares not outstanding but which are the subject of currently exercisable options have been considered



outstanding for the purpose of computing the percentage of outstanding shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of shares owned by any of the other listed persons.

- (2) Consists of 1,421,045 held of record by Mr. Lau and options to purchase 295,000 shares granted to Mr. Lau under the Company's stock option plans. Mr. Lau's options are exercisable at a weighted average exercise price of \$10.41 per share, with terms expiring from September 30, 2013 to January 20, 2018.
- (3) Consists of 1,225,750 held of record by Mr. Li and options to purchase 295,000 shares granted to Mr. Li under the

Company's stock  
option plans.

Mr. Li's options  
are exercisable  
at a weighted  
average exercise  
price of \$10.41  
per share, with  
terms expiring  
from  
September 30,  
2013 to  
January 20,  
2018.

- (4) Based on  
Schedule 13G  
filed with the  
SEC on  
February 16,  
2010.

#### **Change in the Percentage Ownership Held by Major Shareholders**

The following table reflects the percentage of beneficial ownership of Deswell's common shares by its major (five percent or more) shareholders during the past three years (listed in descending order based on shareholdings at June 30, 2010):

| <b>Name of beneficial owner or identity of group</b> | <b>Percentage Ownership at June 30,<sup>(1)</sup></b> |                    |                    |
|--|---|--------------------|--------------------|
|  | <b>2008</b>   | <b>2009</b>        | <b>2010</b>        |
| Richard Pui Hon Lau                                  | 10.2  | 10.6               | 10.4               |
| Chin Pang Li   | 9.0   | 9.4                | 9.2                |
| FMR LLC and Edward C. Johnson 3d                     | 5.5 <sup>(2)</sup>                                    | <sup>(3)</sup>     | 6.1 <sup>(4)</sup> |
| Wellington Management Company, LLP                   | 11.4 <sup>(5)</sup>                                   | <sup>(6)</sup>     | <sup>(6)</sup>     |
| Royce & Associates, LLC                              | 8.6 <sup>(7)</sup>                                    | 5.3 <sup>(8)</sup> | <sup>(9)</sup>     |
| Chi Wai Leung  | 8.4   | <sup>(10)</sup>    | <sup>(10)</sup>    |

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- (1) Based on 15,790,810 shares outstanding on June 30, 2008 and 2009, respectively, and 16,191,810 shares outstanding on June 30, 2010. In accordance with Rule 13d-3(d) (1) under the Securities Exchange Act of 1934, common shares not outstanding but which are the subject of currently exercisable options have been considered outstanding for the purpose of computing the percentage of outstanding common shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of common shares owned by any of the other listed persons.
- (2) Based on Amendment

No. 5 to  
Schedule 13G  
filed by the  
listed persons  
with the SEC on  
February 14,  
2008.

(3) Less than  
5 percent based  
on Amendment  
No. 6 to  
Schedule 13G  
filed by the  
listed persons  
with the SEC on  
February 17,  
2009.

(4) Based on  
Schedule 13G  
filed by the  
listed persons  
with the SEC on  
February 16,  
2010.

(5) Based on  
Amendment  
No. 5 to  
Schedule 13G  
filed by the  
listed persons  
with the SEC on  
February 14,  
2008.

(6) Less than  
5 percent based  
on Amendment  
No. 7 to  
Schedule 13G  
filed by the  
listed person  
with the SEC on  
January 12,  
2009 and the  
absence of any  
Schedule 13D  
or 13G filing by  
the listed person

since then.

- (7) Based on Amendment No. 7 to Schedule 13G filed by the listed person with the SEC on February 1, 2008.
- (8) Based on Amendment No. 8 to Schedule 13G filed by the listed person with the SEC on January 23, 2009.
- (9) Less than 5 percent based on Amendment No. 9 to Schedule 13G filed by the listed person with the SEC on January 27, 2010.
- (10) Mr. Leung retired as Executive Director of Engineering for Plastic Operations and a member of Deswell's Board of Directors effective on January 1, 2009. Deswell was advised in 2009 that Mr. Leung's shareholdings at June 30, 2009 were less than

5 percent. Since there have been no Schedule 13D or 13G filings by Mr. Leung with the SEC since then that would indicate otherwise, Deswell believes that Mr. Leung's shareholdings remained at less than 5 percent at June 30, 2010.

All of the holders of the Company's common shares (including Deswell's major shareholders) have equal voting rights with respect to the common shares held. As of June 30, 2010, approximately 24 holders of record, who, management believes, held for more than 3,000 beneficial owners, held Deswell's common shares. According to information supplied to the Company by its transfer agent, at June 30, 2010, 16 holders of record with addresses in the United States held approximately 13.4 million of our outstanding common shares.

**Related Party Transactions**

Deswell had no transactions of the kind specified in Item 7.B. of Form 20-F from April 1, 2009 through June 30, 2010, the latest practical date prior to filing of this Report.

Since Deswell completed its initial public offering in the United States, it has been Deswell's policy that all transactions between Deswell and any interested director or executive officer be approved by a majority of the disinterested directors and be on terms that are no more favorable than would be available from an independent third party.

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**Item 8. FINANCIAL INFORMATION**

**Financial Statements**

Our Consolidated Financial Statements are set forth under Item 18 Financial Statements.

**Legal Proceedings**

The Company is not involved in any material legal proceedings.

**Export Sales**

Information regarding our export sales is provided in Item 4 Information on the Company Business Overview Customers and Marketing.

**Dividend Policy**

Commencing with the fiscal year ended March 31, 2003, the Company announced it would pay cash dividends on a quarterly basis based upon the Company's quarterly results. Under this dividend policy, the Company declared and paid dividends during the year ended March 31,

2008 aggregating \$9,523,000, \$2,574,000 of which was based on results for the last quarter of the year ended March 31, 2007 and \$6,949,000 of which was based on results for the first three quarters of the year ended March 31, 2008;

2009 aggregating \$3,790,000, \$1,895,000 of which was based on results for the last quarter of the year ended March 31, 2008 and \$1,895,000 of which was based on results for the first three quarters of the year ended March 31, 2009 ; and

2010 aggregating \$1,619,000, which was based on results for the second quarter of the year ended March 31, 2010.

The Company currently plans to continue its quarterly dividend policy as announced, but such plans and policy for future dividends consist of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Whether future dividends will be declared will depend upon the Company's future growth and earnings, of which there can be no assurance, and the Company's cash flow needs for future development, which growth, earning or cash flow needs may be adversely affected by one or more of the factors discussed in Item 3. Key Information Risk Factors. Accordingly, there can be no assurance that future cash dividends on the Company's common shares will be declared, what the amounts of such dividends will be or whether such dividends, once declared for a specific period will continue for any future period or at all.

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**Item 9. THE OFFER AND LISTING**

The Company's shares are traded exclusively on the NASDAQ Global Market under the symbol DSWL .

The following chart shows the high and low sale prices per share of Deswell shares as reported by The NASDAQ Global Market for each of Deswell's fiscal years in the five-year period ended March 31, 2010:

The following chart shows the high and low sale prices per share of Deswell shares as reported by the NASDAQ Global Market during each of the quarters in the two-year period ended March 31, 2010.

The following chart shows the high and low sale prices per share of Deswell shares as reported by The NASDAQ Global Market during each of the months in the six-month period ended June 30, 2010.



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**Item 10. ADDITIONAL INFORMATION**

**Share Capital**

Not applicable to Deswell.

**Memorandum and Articles of Association**

Effective December 13, 2007, we amended and restated our Memorandum and Articles of Associations (collectively the 2007 Charter ), the instruments governing a company organized under the law of the British Virgin Islands, which are comparable in purpose and effect to certificates or articles of incorporation and bylaws of corporations organized in a state of the United States.

Effective March 26, 2010, we amended Regulation 6.15 of our Articles of Association to reduce the number of our outstanding common shares that must be present in person or by proxy in order to hold any meeting of shareholders from no less than 50 percent to no less than 33<sup>1</sup>/<sub>3</sub> percent.

Under our 2007 Charter, as amended through March 26, 2010:

our shares are eligible for a direct registration system operated by a securities depository in accordance with Nasdaq Marketplace Rule 5210(c) (formerly Rule 4350(1)).

various consequential amendments were made to our Memorandum and Articles of Association in accordance with the advice from our US and BVI counsel so as to (a) be consistent with the BVI Business Companies Act, 2004, as amended (the Act ), the Act having come into force on January 1, 2004 superseding in certain respects the International Business Companies Act, 1984, the relevant legislation which had previously governed us and (b) to make conforming changes resulting from the transition of the NASDAQ Stock Market s operations on August 1, 2006 to that of a national securities exchange in the United States.

certain special provisions of our Memorandum and Articles of Association that we adopted in preparation for our initial public offering of securities in the United States.

provisions were added in recognition of, and to assure compliance with, certain laws, rules and regulations of the United States applicable to us, including the Sarbanes-Oxley Act of 2002, and the Marketplace Rules of the NASDAQ Stock Market.

holders of our shares:

are entitled to one vote for each whole share on all matters to be voted upon by shareholders, including the election of directors.

do not to have cumulative voting rights in the election of directors.

are entitled to receive dividends if and when declared by our board of directors out of funds legally available under British Virgin Islands law.

all of common shares are equal to each other with respect to liquidation and dividend rights.

in the event of our liquidation, all assets available for distribution to the holders of our common shares are distributable among them according to their respective holdings.

*Objects and Purposes*

Our objects and purposes are described in Clause 5 of our Memorandum of Association and are generally to engage in any act or activity that is not prohibited under the laws of the British Virgin Islands.

*Directors*

Our Articles of Association (Regulation 12.4) provides that except as otherwise provided in the BVI Business Companies Act, 2004 (No. 16 of 2004) the British Virgin Islands corporate law that governs BVI companies like Deswell no agreement or transaction between the Company and one or more of its directors or any person in which any director has a financial interest or to whom any director is related, including as a director of that other person, is

void or voidable for this reason only or by reason only that the director is present at the meeting of

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directors or at the meeting of the committee of directors that approves the agreement or transaction or that the vote or consent of the director is counted for that purpose if the material facts of the interest of each director in the agreement or transaction and his interest in or relationship to any other party to the agreement or transaction are disclosed in good faith or are known by the other directors and such agreement or transaction has been approved by the irrevocable vote of a majority of the Company's directors, including at least, one Independent Director. In addition, the favorable vote of a majority of the directors, including at least one Independent Director, shall be required to approve any transaction or agreement between the Company and any officer of the Company or any person or entity holding 10 percent or more of the outstanding Shares.

Our Articles of Association (Regulation 7.11) provide that the directors may by a resolution of directors, fix the emoluments of directors with respect to services to be rendered in any capacity to the Company.

British Virgin Islands law and our Articles of Association provide that the management of the business and the control of Deswell shall be vested in the directors, who in addition to the powers and authorities expressly conferred by the Articles of Association, may also exercise all such powers, and do all such acts and things, as may be done by Deswell and are not by the Articles of Association or British Virgin Islands law expressly directed or required to be exercised or done by a meeting of shareholders. Our Articles of Association provide that the directors may by resolution exercise all the powers of Deswell to borrow money and to mortgage or charge its undertakings and property or any part thereof, to issue debentures, debenture stock and other securities whenever money is borrowed or as security for any debt, liability or obligation of Deswell or of any third party.

British Virgin Islands law and our Memorandum of Association and Articles of Association do not contain an age limit requirement for our directors. Under our Articles of Association, no shares are required for director's qualification.

*Rights, Preferences and Restrictions of Authorized and Outstanding Shares and Changes to Rights of Shareholders*

Deswell has one class and series of shares authorized or outstanding: common shares, no par value per share. Our authorized capital consists of 30,000,000 common shares, no par value per share, of which 16,191,810 common shares were outstanding on June 30, 2010.

Holders of our common shares are entitled to one vote for each whole share on all matters to be voted upon by shareholders, including the election of directors. Holders of our common shares do not have cumulative voting rights in the election of directors. All of our common shares are equal to each other with respect to liquidation and dividend rights. Holders of our common shares are entitled to receive dividends if and when declared by our board of directors out of funds legally available under British Virgin Islands law. In the event of our liquidation, all assets available for distribution to the holders of our common shares are distributable among them according to their respective holdings. Holders of our common shares have no preemptive rights to purchase any additional, unissued common shares.

*Calling Annual General Meetings and Extraordinary General Meetings of Shareholders*

British Virgin Islands law does not require a company, such as Deswell, to have an annual meeting. Our Articles of Association do, however, require an annual meeting of shareholders for the election of directors and for such other business as may come before the meeting (Regulation 6.3).

Under British Virgin Islands law, unless otherwise provided by a company's Memorandum of Association or Articles of Association, the directors may call meetings of shareholders at any time (Regulation 6.1) and upon the written request of shareholders entitled to exercise ten percent or more of the voting rights in respect of the matter for which the meeting is requested, the directors shall convene a meeting of Shareholders (Regulation 6.2).

British Virgin Islands law and our Articles of Association state that the directors may fix the date that notice is given of a meeting of shareholders, whether extraordinary or annual, as the record date for determining those shares that are entitled to vote at the meeting. (Regulation 6.6)

British Virgin Islands law and our Articles of Association provide that notice of all meetings of shareholders, stating the time, place and purposes thereof, shall be given not fewer than seven days before the date of the proposed meeting to those persons whose names appear as shareholders in our share register on the date of the notice and are entitled to vote at the meeting. (Regulation 6.7)

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### *Limitations on Share Ownership*

British Virgin Islands law and our Memorandum of Association and Articles of Association do not impose any limitations on the right of anyone to own, hold or exercising voting rights to our common shares.

### *Potential Anti-Takeover Deterrence*

Neither our Articles of Association nor Memorandum of Association contain provisions that would have an effect of delaying, deferring or preventing a change in control of Deswell and that would operate only with respect to a merger, acquisition or corporate restructuring involving Deswell or any of its subsidiaries. However, pursuant to our Memorandum and Articles of Association and pursuant to the laws of the British Virgin Islands, our board of directors without shareholder approval may amend our Memorandum and Articles of Association (provided that a majority of our independent directors do not vote against the amendment and provided further that our directors may not make an amendment that

- (a) to restrict the rights or powers of the shareholders to amend the Memorandum or the Articles;
- (b) to change the percentage of shareholders required to pass a Resolution of Shareholders to amend the Memorandum or the Articles;
- (c) in circumstances where the Memorandum or the Articles cannot be amended by the Shareholders;
- (d) change Clause 7 of our Articles of Association conferring the rights of our shareholders to one vote per share, the right to equal share in dividend paid by the company or to surplus assets on liquidation; or
- (e) change Clause 9 of our Articles of Association which sets forth rights of our shareholders and directors to amend our Memorandum and Articles of Association.

Our directors' ability to amend our Memorandum and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in control of Deswell, including a tender offer to purchase our common shares at a premium over the then current market price.

### *Ownership Information*

Neither our Articles of Association nor Memorandum of Association provide that information about our shareholders, even those owning significant percentages of our shares, must be disclosed.

### *Differences from United States Law*

The laws of the British Virgin Islands governing the provisions of our Articles of Association and Memorandum of Association discussed above are not significantly different than the laws governing similar provisions in the charter documents of Delaware companies, other than with respect to amending our Memorandum of Association without shareholder approval and with respect to potential anti-takeover deterrence. Delaware law requires shareholders to approve any amendments to a corporation's Certificate of Incorporation and contains provisions restricting a Delaware corporation's rights to engage in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder unless the business combination is approved in the manner prescribed under Delaware law.

### **Material Contracts**

The following summarizes each material contract, other than contracts entered into in the ordinary course of business, to which Deswell or any subsidiary of Deswell is a party for the two years immediately preceding the filing of this report.

On August 5, 2009, Deswell entered into a Sale and Purchase Agreement with a third party to sell real property Deswell owns in Shekou, Shenzhen, China that it formerly used for its plastic injection molding operations for RMB 50,000,000 (approximately \$7.3 million, based on an exchange rate of 1:6.8309 on August 5, 2009 as reported on <http://forex-history.net>). The sale closed on September 30, 2009 after required local government transfer and other approvals have been obtained. An English summary of the Sale and Purchase Agreement is incorporated by reference as Exhibit 4.4 to this Report.

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**Taxation**

**United States Federal Income Tax Consequences**

The discussion below is for general information only and is not, and should not be interpreted to be, tax advice to any holder of our common shares. Each holder or a prospective holder of our common shares is urged to consult his, her or its own tax advisor.

*General*

This section is a general summary of the material United States federal income tax consequences to U.S. Holders, as defined below, of the ownership and disposition of our common shares as of the date of this report. This summary is based on the provisions of the Internal Revenue Code of 1986, as amended, or the Code, the applicable Treasury regulations promulgated and proposed thereunder, judicial decisions and current administrative rulings and practice, all of which are subject to change, possibly on a retroactive basis. The summary applies to you only if you hold our common shares as a capital asset within the meaning of Section 1221 of the Code. In addition, this summary generally addresses certain U.S. federal income tax consequences to U.S. Holders if we were to be classified as a PFIC. The United States Internal Revenue Service, or the IRS, may challenge the tax consequences described below, and we have not requested, nor will we request, a ruling from the IRS or an opinion of counsel with respect to the United States federal income tax consequences of acquiring, holding or disposing of our common shares. This summary does not purport to be a comprehensive description of all the tax considerations that may be relevant to the ownership of our common shares. In particular, the discussion below does not cover tax consequences that depend upon your particular tax circumstances nor does it cover any state, local or foreign law, or the possible application of the United States federal estate or gift tax. You are urged to consult your own tax advisors regarding the application of the United States federal income tax laws to your particular situation as well as any state, local, foreign and United States federal estate and gift tax consequences of the ownership and disposition of the common shares. In addition, this summary does not take into account any special United States federal income tax rules that apply to a particular U.S. or Non-U.S. holder of our common shares, including, without limitation, the following:

a dealer in securities or currencies;

a trader in securities that elects to use a market-to-market method of accounting for its securities holdings;

a financial institution or a bank;

an insurance company;

a tax-exempt organization;

a person that holds our common shares in a hedging transaction or as part of a straddle or a conversion transaction;

a person whose functional currency for United States federal income tax purposes is not the U.S. dollar;

a person liable for alternative minimum tax;

a person that owns, or is treated as owning, 10% or more, by voting power or value, of our common shares;

certain former U.S. citizens and residents who have expatriated; or

a person who receives our shares pursuant to the exercise of employee stock options or otherwise as compensation.

*U.S. Holders*

For purposes of the discussion below, you are a U.S. Holder if you are a beneficial owner of our common shares who or which is:

an individual United States citizen or resident alien of the United States (as specifically defined for United States federal income tax purposes);

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a corporation, or other entity treated as a corporation for United States federal income tax purposes, created or organized in or under the laws of the United States, any State or the District of Columbia;

an estate whose income is subject to United States federal income tax regardless of its source; or

a trust (x) if a United States court can exercise primary supervision over the trust's administration and one or more United States persons are authorized to control all substantial decisions of the trust or (y) if it was in existence on August 20, 1996, was treated as a United States person prior to that date and has a valid election in effect under applicable Treasury regulations to be treated as a United States person.

If a partnership holds our common shares, the tax treatment of a partner will generally depend upon the status of the partner and upon the activities of the partnership. If you are a partner of a partnership holding our common shares, you should consult your tax advisor.

**Distributions**

Subject to the passive foreign investment company (PFIC) rules discussed below, for cash dividends, the gross amount of any such distribution (other than in liquidation) that you receive with respect to our common shares generally will be taxed to you as dividend income to the extent such distribution does not exceed our current or accumulated earnings and profits (E&P), as calculated for U.S. federal income tax purposes. Such income will be includable in your gross income as ordinary income on the date of receipt. Dividends received by individuals and certain other non-corporate taxpayers in tax years before January 1, 2011 from qualified foreign corporations are taxed at the rate of either 5 percent (zero, for tax years beginning in 2008, 2009 and 2010) or 15 percent, depending upon the particular taxpayer's U.S. federal income tax bracket; provided that the recipient-shareholder has held his or her shares as a beneficial owner for more than 60 days during the 121-day period beginning on the date which is 60 days before the shares' ex-dividend date. Dividends received in tax years beginning after December 31, 2010 will be taxed at higher ordinary income tax rates. A foreign corporation is a qualified foreign corporation if the stock with respect to which it pays dividend is traded on an established securities market in the United States, provided that the foreign corporation is not a PFIC. Our stock is traded on an established securities market in the United States, although we cannot guarantee that our stock will be so traded in the future. We believe that we were not a PFIC for U.S. federal income purposes for our fiscal years ended March 31, 2009 or 2010. No assurance can be given, however, that the IRS may not disagree and seek to treat us as a PFIC. See **Passive Foreign Investment Company (PFIC)** below. If we are a PFIC with respect to a particular U.S. Holder, dividends received from us will be taxed at regular ordinary income tax rates. Holders of our shares should consult their own tax advisers regarding the availability of the reduced dividend tax rate in light of their own particular circumstances.

To the extent any distribution exceeds our E&P, the distribution will first be treated as a tax-free return of capital to the extent of your adjusted tax basis in our common shares and will be applied against and reduce such basis on a dollar-for-dollar basis (thereby increasing the amount of gain and decreasing the amount of loss recognized on a subsequent disposition of such shares). To the extent that such distribution exceeds your adjusted tax basis, the distribution will be taxed as gain recognized on a sale or exchange of our common shares. See **Sale, Exchange or Other Disposition of Our Common Shares**, below. Because we are not a U.S. corporation, no dividends-received deduction will be allowed to corporations with respect to dividends paid by us.

For United States foreign tax credit limitation purposes, dividends received on our common shares will be treated as foreign source income and will generally be passive category income, or in the case of certain holders, general category income. You may be eligible, subject to a number of complex limitations, to claim a foreign tax credit in respect of foreign withholding taxes, if any, imposed on dividends paid on our common shares. The rules governing United States foreign tax credits are complex, and we recommend that you consult your tax advisor regarding the applicability of such rules to you.

**Sale, Exchange or Other Disposition of Our Common Shares**

Subject to the PFIC rules discussed below, generally, in connection with the sale, exchange or other taxable disposition of our common shares:

you will recognize capital gain or loss equal to the difference (if any) between:

the amount realized on such sale, exchange or other taxable disposition and



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your adjusted tax basis in such common shares (your adjusted tax basis in the shares you hold generally will equal your U.S. dollar cost of such shares);

such gain or loss will be long-term capital gain or loss if your holding period for our common shares is more than one year at the time of such sale or other disposition;

such gain or loss will generally be treated as United States source for United States foreign tax credit purposes; and

your ability to deduct capital losses is subject to limitations.

**Passive Foreign Investment Company (PFIC)**

A U.S. Holder generally would be subject to a special tax regime (that differs in certain material respects from that described above) if we were a PFIC at any time during which such Holder held our shares.

An actual determination of PFIC status is factual in nature and cannot be made until the close of the applicable tax year. Based on the composition of our annual gross income and the nature and book value of our assets and the total market value, or market cap, of our shares at the end of each quarter of our fiscal years ended March 31, 2009 and 2010, we believe that we were not a PFIC for U.S. federal income purposes for our fiscal years ended March 31, 2009 or 2010. No assurance can be given, however, that the IRS may not disagree and seek to treat us as a PFIC.

We have not conducted an appraisal of the actual fair market value of our assets to support our conclusion regarding our PFIC status. If we conducted such appraisal, it might not result in a fair market value of our assets being sufficiently greater than the aggregate value of our market cap to support our conclusion regarding our PFIC status. Even if such appraisal did so support our conclusion as to our PFIC status, such appraisal may not be enough to establish to the satisfaction of the IRS that the fair market value of our assets, which would, or we believe should, not be considered passive, was sufficiently greater than the aggregate value of our market cap.

A foreign corporation will be treated as a PFIC for United States federal income tax purposes if, after applying relevant look-through rules with respect to the income and assets of subsidiaries, 75% or more of its gross income consists of certain types of passive income (the income test) or 50% or more of the gross value of its assets is attributable to assets that produce passive income or are held for the production of passive income (the asset test). For this purpose, passive income generally includes dividends, interest, royalties, rents (other than rents and royalties derived in the active conduct of a trade or business), annuities and gains from assets that produce passive income.

As a result of the classification as a PFIC, a special tax regime would apply to both (a) any excess distribution by us (generally, the U.S. Holder's ratable share of distributions in any year that are greater than 125% of the average annual distributions received by such U.S. Holder in the three preceding years or its holding period, if shorter) and (b) any gain recognized on the sale or other disposition of your ordinary shares. Under the PFIC regime, any excess distribution and recognized gain would be treated as ordinary income. The U.S. federal income tax on such ordinary income is determined under the following steps: (i) the amount of the excess distribution or gain is allocated ratably over the US Holder's holding period for our ordinary shares; (ii) tax is determined for amounts allocated to the first year in the holding period in which we were classified as a PFIC and all subsequent years (except the year in which the excess distribution was received or the sale occurred) by applying the highest applicable tax rate in effect in the year to which the income was allocated; (iii) an interest charge is added to this tax calculated by applying the underpayment interest rate to the tax for each year determined under the preceding sentence from the due date of the income tax return for such year to the due date of the return for the year in which the excess distribution or sale occurs; and (iv) amounts allocated to a year prior to the first year in the U.S. Holder's holding period in which we were classified as a PFIC or to the year in which the excess distribution or the disposition occurred are taxed as ordinary income and no interest charge applies. The interest charge is non-deductible by individuals but is generally deductible by corporations

If we were treated as a PFIC, a U.S. Holder of our shares would generally be subject to the PFIC rules described above with respect to distributions by us, and dispositions by us of the stock of, any direct or indirect subsidiaries of ours that are classified as PFICS under either the asset test or the income test, as if such holder received directly its pro-rata share of the proceeds from such disposition.

A U.S. Holder may generally avoid the PFIC regime by making a qualified electing fund election which generally provides that, in lieu of the foregoing treatment, our earnings, on a pro rata basis, would be currently included in their gross income. However, we may be unable or unwilling to provide information to our U.S. Holders that would enable them to make a qualified electing fund election; thus, such election may not be available.

In addition, U.S. Holders may generally avoid the PFIC regime by making the mark-to-market election with respect to our common shares as long as we are a PFIC and our common shares are considered to be readily tradable on an established securities market within the United States. Marking-to-market, in this context, means including in ordinary income each taxable year the excess, if any, of the fair market value of our common shares over your tax adjusted basis in such common shares as of the end of each year. This mark-to-market election generally enables a U.S. Holder to avoid the deferred interest charge that would otherwise be imposed on them if we were to be classified as a PFIC. However, if we were a PFIC, such election would not be available for any of our

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subsidiaries that also may be classified as PFICs, and those subsidiaries would continue to be subject to the PFIC rules described above.

If we are treated as a PFIC at any time that you hold our shares but cease to be classified as a PFIC in a later year, we will continue to be classified as a PFIC with respect to you unless you make a deemed sale election in a timely manner to be taxed as if you sold your shares on the last day of our last year during which we were treated as a PFIC. In this case, you would pay tax on the gain on the deemed sale treated as ordinary income and an interest charge, and no loss will be allowed to you. A timely deemed sale election can also be made with respect to our subsidiaries that are treated as PFICs, in which case you will be taxed on the amount of gain treated as ordinary income and pay an interest charge as if the stock of such subsidiaries had been actually sold or disposed of by us while we were a PFIC and you held our shares. If we subsequently become a PFIC, you will again be subject to the general PFIC rules discussed herein. We do not expect to monitor our status (or the status of any of our subsidiaries) as a PFIC for the current taxable year or in any future taxable year and, therefore, we may not be able to inform you as whether we have become a PFIC in any given year or whether we have subsequently ceased to be a PFIC.

If we were treated as a PFIC, each U.S. Holder would be required to make an annual return on IRS Form 8621, reporting, among other things, distributions received and gain realized with respect to each PFIC in which such holder holds a direct or indirect interest, and may be required to provide other information as specified by the IRS. In this regard, we note, in particular, that under recently enacted legislation U.S. Holders may be subject to further reporting requirements in connection with the annual filing of their respective U.S. federal income tax returns with respect to shareholdings in foreign corporations, which may include affirming whether or not a foreign corporation in which such U.S. Holder has invested is (or is not) a PFIC irrespective of whether any distributions have been received, the U.S. Holder has disposed of any stock of the foreign corporation, or the foreign corporation has disposed of any stock of its foreign subsidiaries in the relevant taxable year.

An actual determination of PFIC status is highly factual in nature. Given the complexity of the issues that may result if we are classified as or become a PFIC, you are urged to consult your own tax advisors with respect to the tax consequences to you in the event that this should occur, in view of your particular circumstances.

***Non-U.S. Holders***

If you are not a U.S. Holder, you are a Non-U.S. Holder.

**Distributions on Our Common Shares**

You generally will not be subject to U.S. federal income tax, including withholding tax, on distributions made on our common shares unless:

you conduct a trade or business in the United States and

the distributions are effectively connected with the conduct of that trade or business (and, if an applicable income tax treaty so requires as a condition for you to be subject to U.S. federal income tax on a net income basis in respect of income from our common shares, such distributions are attributable to a permanent establishment that you maintain in the United States).

If you meet the two tests above, you generally will be subject to tax in respect of such dividends in the same manner as a U.S. Holder, as described above. In addition, any effectively connected dividends received by a non-U.S. corporation may also, under certain circumstances, be subject to an additional branch profits tax at a 30 percent rate or such lower rate as may be specified by an applicable income tax treaty.

**Sale, Exchange or Other Disposition of Our Common Shares**

Generally, you will not be subject to U.S. federal income tax, including withholding tax, in respect of gain recognized on a sale or other taxable disposition of our common shares unless:

your gain is effectively connected with a trade or business that you conduct in the United States (and, if an applicable income tax treaty so requires as a condition for you to be subject to U.S. federal income tax on a net income basis in respect of gain from the sale or other disposition of our common shares, such gain is attributable to a permanent establishment maintained by you in the United States), or

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you are an individual Non-U.S. Holder and are present in the United States for at least 183 days in the taxable year of the sale or other disposition, and certain other conditions exist.

You will be subject to tax in respect of any gain effectively connected with your conduct of a trade or business in the United States generally in the same manner as a U.S. Holder, as described above. Effectively connected gains realized by a non-U.S. corporation may also, under certain circumstances, be subject to an additional branch profits tax at a rate of 30 percent or such lower rate as may be specified by an applicable income tax treaty.

### **Backup Withholding and Information Reporting**

Payments, including dividends and proceeds of sales, in respect of our common shares that are made in the United States or by a United States related financial intermediary will be subject to United States information reporting rules. In addition, such payments may be subject to United States federal backup withholding tax. You will not be subject to backup withholding provided that:

you are a corporation or other exempt recipient, or

you provide your correct United States federal taxpayer identification number and certify, under penalties of perjury, that you are not subject to backup withholding.

Amounts withheld under the backup withholding rules may be credited against your United States federal income tax, and you may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS in a timely manner.

### **British Virgin Islands Tax Consequences**

Under the International Business Companies Act of the British Virgin Islands as currently in effect, a holder of common equity, such as our common shares, who is not a resident of the British Virgin Islands is exempt from British Virgin Islands income tax on dividends paid with respect to the common equity and all holders of common equity are not liable to the British Virgin Islands for income tax on gains realized on sale or disposal of such shares: The British Virgin Islands does not impose a withholding tax on dividends paid by a company incorporated under the International Business Companies Act.

There are no capital gains, gift or inheritance taxes levied by the British Virgin Islands on companies incorporated under the International Business Companies Act. In addition, our common shares are not subject to transfer taxes, stamp duties or similar charges. There is no income tax treaty or convention currently in effect between the United States and the British Virgin Islands.

### **Documents on Display**

Deswell is subject to the information requirements of the Securities and Exchange Act of 1934, and, in accordance with the Securities Exchange Act of 1934, Deswell files annual reports on Form 20-F within six months of its fiscal year end, and submits other reports and information under cover of Form 6-K with the SEC. You may read and copy this information at the SEC's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Recent filings and reports are also available free of charge through the EDGAR electronic filing system at [www.sec.gov](http://www.sec.gov). You can also request copies of the documents, upon payment of a duplicating fee, by writing to the public reference section of the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room or accessing documents through EDGAR.

As a foreign private issuer, Deswell is exempt from the rules under the Securities Exchange Act of 1934 prescribing the furnishing and content of proxy statements to shareholders.

## **Item 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Exchange Controls**

There are no exchange control restrictions on payments of dividends on the Company's common shares or on the conduct of the Company's operations either in Macao, where the Company's principal executive offices are located, or the British Virgin Islands, where the Company is incorporated. Other jurisdictions in which the Company conducts operations may have various exchange controls. There are no material British Virgin Islands laws which impose foreign exchange controls on the Company or that affect the payment of dividends, interest or other payments to nonresident holders of the Company's common shares. British Virgin Islands law and the



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Company's Memorandum and Articles of Association impose no limitations on the right of nonresident or foreign owners to hold the Company's Securities or vote the Company's common shares.

To the extent that the Company may decide to pay cash dividends in the future, such dividends will be declared from the retained earnings, i.e., surplus, as determined by resolution of the directors of the Company. As the Company is a holding company, the amount of its retained earnings will be limited by the amount of dividends that can be declared by its subsidiaries. Dividends declared by subsidiaries will be based on the profits reported in their statutory accounts prepared in accordance with generally accepted accounting principles in the relevant countries, primarily Macao and China, which differ from U.S. GAAP. See Note 1 of Notes to Consolidated Financial Statements. China's laws and regulations regulate dividend distribution and repatriation by the Company's China subsidiaries. To date these controls, with the exception of a requirement that 10% of profits to be reserved for future developments and staff welfare, have not had and are not expected to have a material impact on the Company's financial results.

**Foreign Currency Risk**

At March 31, 2008, 2009 and 2010, the Company had no open forward exchange contracts or option contracts.

Cash on hand at March 31, 2010 of \$35,120,000 was held in the following currencies:

|                       | <b>Equivalent<br/>U.S. Dollar<br/>Holdings</b> |
|-----------------------|--|
| United States dollars | \$18,155,000                                   |
| Hong Kong dollars     | 13,633,000                                     |
| Chinese RMB           | 3,199,000                                      |
| Macao dollars         | 100,000  |
| Euro                  | 17,000   |
| Japanese yen          | 14,000   |
| Pounds sterling       | 2,000  |

See discussion of Exchange Rate Fluctuation in Item 5 Operating and Financial Review and Prospects.

**Interest Rate Risk**

Our interest expenses and income are sensitive to changes in interest rates, as all of our cash reserves and borrowings are subject to interest rate changes. Cash on hand of \$11.0 million as at March 31, 2010 was invested in short-term interest bearing investments. As such, interest income will fluctuate with changes in short term interest rates. As of March 31, 2010 we had no long-term debt or short-term bank loans outstanding on our credit facilities.

**Item 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

**PART II****Item 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

Not Applicable.

**Item 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

Not Applicable.

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**Item 15. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

The Company's management, with the participation of its Chief Executive Officer and Chief Financial Officer, conducted an evaluation of our disclosure controls and procedures as required by paragraph (b) of Rule 13a-15 or 15d-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of March 31, 2010.

Based on this evaluation, the Company's management, including its Chief Executive Officer and Chief Financial Officer concluded that as of March 31, 2010 such disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by the Company in reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Report of Management on Internal Control over Financial Reporting**

Deswell's management is responsible for establishing and maintaining adequate internal control over financial reporting. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal controls will prevent all errors 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. 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, a 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.

A deficiency in internal control over financial reporting exists, as defined under Standards of the Public Company Accounting Oversight Board, when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Deswell's management, including its Chief Executive Officer and Chief Financial Officer, assessed the effectiveness of our internal control over financial reporting as of March 31, 2010. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework.

Based on the assessment, Deswell's management, including its Chief Executive Officer and Chief Financial Officer, concluded that, as of March 31, 2010, the Company's internal control over financial reporting was effective based on above described criteria.

**Attestation Report of the Registered Public Accounting Firm**

The effectiveness of internal control over financial reporting as of March 31, 2010 has been audited by BDO Limited, an independent registered public accounting firm with a report to the Shareholders and the Board of Directors of Deswell Industries, Inc., which is set forth immediately below.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders and the Board of Directors of  
Deswell Industries, Inc.

We have audited the internal control over financial reporting of Deswell Industries, Inc. and its subsidiaries (the Company ) as of March 31, 2010, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of the inherent limitation, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Deswell Industries, Inc. and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as of March 31, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Deswell Industries, Inc. and its subsidiaries as of March 31, 2009 and 2010, and the related consolidated statements of income and comprehensive income, shareholders’ equity and cash flows for each of the three years in the period ended March 31, 2010 and our report dated July 29, 2010 expressed an unqualified opinion thereon.

/s/ BDO Limited  
BDO Limited

Hong Kong, July 29, 2010



**Table of Contents****Changes in Internal Controls**

There were no changes in the Company's internal controls during the period covered by this Report that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

**Item 16. RESERVED****Item 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Deswell's Board of Directors has determined that at least one person serving on the Audit Committee is an audit committee financial expert as defined under Item 16A(b) of Form 20-F. Mr. Allen Yau-Nam Cham is an audit committee financial expert.

**Item 16B. CODE OF ETHICS**

The Company has adopted a Code of Ethics for the Chief Executive Officer and Chief Financial Officer, which applies to the Company's principal executive officer and to its principal financial and accounting officers. A copy of the Code of Ethics is attached as Exhibit 11.1 to this Annual Report on Form 20-F.

**Item 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Deswell's principal accountants for the audit of its financial statements for each of the two years in the period ended March 31, 2010 was BDO Limited ( BDO ).

The following table presents the aggregate fees for professional services and other services rendered by the principal accountant to Deswell in the years ended March 31, 2009 and 2010.

|                                   | <b>Year ended March 31,</b> |             |
|-----------------------------------|-----------------------------|-------------|
|                                   | <b>2009</b>                 | <b>2010</b> |
|                                   | <b>(In thousands)</b>       |             |
| Audit fees <sup>(1)</sup>         | \$ 226                      | \$ 206      |
| Audit-related fees <sup>(2)</sup> |                             |             |
| Tax fees <sup>(3)</sup>           |                             |             |
| All other fees <sup>(4)</sup>     |                             |             |
|                                   | \$ 226                      | \$ 206      |

(1) Audit Fees consist of fees billed for the annual audit of our consolidated financial statements and the statutory financial statements of our subsidiaries. They also include fees billed for other audit services, which are those services that only the external auditor reasonably can

provide, and include the provision for consents relating to the review of documents filed with the SEC.

- (2) There were no other audit-related fees billed by the principal accountant during the last two fiscal years for assurance and related services that were reasonably related to the performance of the audit not reported under Audit Fees above.
- (3) There were no tax fees billed by the principal accountant during the last two fiscal years.
- (4) There were no other fees billed by the principal accountant during the last two fiscal years for products and services provided by BDO.

**Audit Committee Pre-approval Policies and Procedures**

The Audit Committee's policy is to pre-approve all audit and permissible non-audit related services provided by the independent auditors. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services. Management will periodically report to the Audit Committee regarding the extent of services provided and the fees for the services performed by the independent auditors in accordance with this pre-approval

policy. The Audit Committee may also pre-approve particular services on a case-by-case basis.

**Item 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR THE AUDIT COMMITTEE.**

As of the date of this Report, Deswell is not availing itself of an exemption from the independence standards contained in paragraph (b)(1)(iv) of Rule 10A-3 under the Securities Exchange Act of 1934 (except paragraph (b)(1)(iv)(B) of that Rule), the general exemption contained in paragraph (c)(3) of that Rule or the last sentence of paragraph (a)(3) of that Rule.

**Item 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATE PURCHASERS**

Not applicable to Deswell.

**Item 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not applicable to Deswell.

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**Item 16G. CORPORATE GOVERNANCE**

For information regarding whether our corporate governance standards differ from those applied to US domestic issuers, see the discussion under Other Committees; NASDAQ Compliance in Item 6. Directors and Senior Management of this Report.

**PART III**

**Item 17. FINANCIAL STATEMENTS**

Not Applicable.

**Item 18. FINANCIAL STATEMENTS**

The following financial statements are filed as part of this Report:

|   | <b>Page</b> |
|---|-------------|
| <u>Report of Independent Registered Public Accounting Firm</u>    | F-1         |
| <u>Consolidated Balance Sheets</u>                                | F-2         |
| <u>Consolidated Statements of Income and Comprehensive Income</u> | F-3         |
| <u>Consolidated Statements of Shareholders' Equity</u>            | F-4         |
| <u>Consolidated Statements of Cash Flows</u>                      | F-5         |
| <u>Notes to Consolidated Financial Statements</u>                 | F-6         |

All other schedules for which provisions are made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders and the Board of Directors of  
Deswell Industries, Inc.

We have audited the accompanying consolidated balance sheets of Deswell Industries, Inc. and subsidiaries (the Company ) as of March 31, 2009 and 2010, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended March 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Deswell Industries, Inc. and subsidiaries as of March 31, 2009 and 2010, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Deswell Industries, Inc.'s internal control over financial reporting as of March 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated July 29, 2010 expressed an unqualified opinion thereon.

/s/ BDO Limited  
BDO Limited

Hong Kong, July 29, 2010

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**DESWELL INDUSTRIES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**(U.S. dollars in thousands)**

|  | <b>March 31,</b>  |                   |
|--|-------------------|-------------------|
|  | <b>2009</b>       | <b>2010</b>       |
| <b>ASSETS</b>  |                   |                   |
| Current assets:  |                   |                   |
| Cash and cash equivalents  | \$ 23,134         | \$ 35,120         |
| Marketable securities (note 3)   | 100               | 5,673             |
| Accounts receivable, less allowances for doubtful amounts of \$349 and \$223 at March 31, 2009 and 2010, respectively                        | 22,227            | 14,399            |
| Inventories (note 4)   | 21,445            | 15,808            |
| Assets held for sale (note 6)  | 987               |                   |
| Prepaid expenses and other current assets (note 5)   | 1,887             | 1,844             |
| <b>Total current assets</b>  | <b>69,780</b>     | <b>72,844</b>     |
| Property, plant and equipment-net (note 6)   | 66,564            | 60,705            |
| Deferred income tax assets (note 9)  | 746               | 70                |
| Goodwill (note 7)  | 392               | 392               |
| <b>Total assets</b>  | <b>\$ 137,482</b> | <b>\$ 134,011</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                   |                   |
| Current liabilities:   |                   |                   |
| Accounts payable   | \$ 10,370         | \$ 7,298          |
| Accrued payroll and employee benefits  | 2,473             | 2,570             |
| Customer deposits  | 1,460             | 883               |
| Other accrued liabilities (note 8)   | 2,167             | 1,905             |
| Income taxes payable   | 705               |                   |
| Deferred income tax liabilities (note 9)   |                   | 340               |
| <b>Total current liabilities</b>   | <b>17,175</b>     | <b>12,996</b>     |
| Commitments and contingencies (note 10)  |                   |                   |
| Shareholders equity:   |                   |                   |
| Common shares nil par value-authorized 30,000,000 shares, shares issued and outstanding March 31, 2009 15,790,810; March 31, 2010 16,191,810 | 49,923            | 50,803            |
| Additional paid-in capital   | 7,771             | 7,719             |
| Accumulated other comprehensive income   | 5,316             | 5,316             |
| Retained earnings  | 57,297            | 57,177            |
| <b>Total shareholders equity</b>   | <b>120,307</b>    | <b>121,015</b>    |

|  |            |            |
|--|------------|------------|
| Total liabilities and shareholders' equity | \$ 137,482 | \$ 134,011 |
|--|------------|------------|

See accompanying notes to consolidated financial statements.

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**DESWELL INDUSTRIES, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**  
**(U.S. dollars in thousands, except per share data)**

|   | <b>Year ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Net sales   | \$ 143,806                  | \$ 131,738  | \$ 81,614   |
| Cost of sales   | 117,373                     | 111,570     | 68,958      |
| Gross profit  | 26,433                      | 20,168      | 12,656      |
| Selling, general and administrative expenses                              | 19,601                      | 19,291      | 15,505      |
| Other income (expenses), net  | 1,838                       | (132)       | 4,594       |
| Operating income  | 8,670                       | 745         | 1,745       |
| Non-operating income, net   | 521                         | 168         | 444         |
| Income before income taxes  | 9,191                       | 913         | 2,189       |
| Income taxes (note 9)   | 104                         | (282)       | 690         |
| Net income  | 9,087                       | 1,195       | 1,499       |
| Net income attributable to non-controlling interests                      | 228                         |             |             |
| Net income attributable to Deswell Industries, Inc.                       | 8,859                       | 1,195       | 1,499       |
| Other comprehensive income  |                             |             |             |
| Foreign currency translation adjustment                                   | 2,628                       | 1,582       |             |
| Comprehensive income attributable to Deswell Industries, Inc.             | \$ 11,487                   | \$ 2,777    | \$ 1,499    |
| Net income per share attributable to Deswell Industries, Inc. (note 2)    |                             |             |             |
| Basic:  |                             |             |             |
| Net income per share  | \$ 0.57                     | \$ 0.08     | \$ 0.09     |
| Weighted average common shares outstanding (shares in thousands)          | 15,517                      | 15,791      | 15,965      |
| Diluted:  |                             |             |             |
| Net income per share  | \$ 0.57                     | \$ 0.08     | \$ 0.09     |
| Weighted average common and potential common shares (shares in thousands) | 15,556                      | 15,805      | 16,039      |

See accompanying notes to consolidated financial statements.

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**DESWELL INDUSTRIES, INC.**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**  
(U.S. dollars in thousands, except per share data)

|   | Common stock<br>Shares<br>outstanding | Amount | Additional<br>paid-in<br>capital | Accumulated<br>other<br>comprehensive<br>income | Retained<br>earnings | Shareholders<br>equity |
|---|---------------------------------------|--------|----------------------------------|---|----------------------|------------------------|
| Balance at March 31,<br>2007  | 15,038,730                            | 42,393 | 7,601                            | 1,106   | 60,555               | 111,655                |
| Stock-based<br>compensation   |                                       |        | 310                              |   |                      | 310                    |
| Exercise of stock options   | 120,000                               | 1,188  | (202)                            |   |                      | 986                    |
| Issue of common stock<br>for acquisition of<br>additional interest in a<br>subsidiary | 632,080                               | 6,342  |                                  |   |                      | 6,342                  |
| Foreign currency<br>translation adjustment  |                                       |        |                                  | 2,628   |                      | 2,628                  |
| Net income  |                                       |        |                                  |   | 8,859                | 8,859                  |
| Dividends (\$0.61 per<br>share)   |                                       |        |                                  |   | (9,523)              | (9,523)                |
| Balance at March 31,<br>2008  | 15,790,810                            | 49,923 | 7,709                            | 3,734   | 59,891               | 121,257                |
| Stock-based<br>compensation   |                                       |        | 62                               |   |                      | 62                     |
| Foreign currency<br>translation adjustment  |                                       |        |                                  | 1,582   |                      | 1,582                  |
| Net income  |                                       |        |                                  |   | 1,195                | 1,195                  |
| Dividends (\$0.24 per<br>share)   |                                       |        |                                  |   | (3,789)              | (3,789)                |
| Balance at March 31,<br>2009  | 15,790,810                            | 49,923 | 7,771                            | 5,316   | 57,297               | 120,307                |
| Stock-based<br>compensation   |                                       |        | 125                              |   |                      | 125                    |
| Exercise of stock options   | 401,000                               | 880    | (177)                            |   |                      | 703                    |
| Net income  |                                       |        |                                  |   | 1,499                | 1,499                  |
| Dividends (\$0.10 per<br>share)   |                                       |        |                                  |   | (1,619)              | (1,619)                |
| Balance at March 31,<br>2010  | 16,191,810                            | 50,803 | 7,719                            | 5,316   | 57,177               | 121,015                |

See accompanying notes to consolidated financial statements.

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**DESWELL INDUSTRIES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(U.S. dollars in thousands)**

|   | <b>Year ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Cash flows from operating activities  |                             |             |             |
| Net income  | \$ 8,859                    | \$ 1,195    | \$ 1,499    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                             |             |             |
| Depreciation and amortization   | 6,940                       | 7,264       | 7,011       |
| Impairment of property, plant and equipment                                       |                             | 176         | 8           |
| Loss (gain) on sale of property, plant and equipment                              | 43                          | 216         | (4,339)     |
| Unrealized holding (gain) loss on marketable securities                           | (9)                         | 16          | (42)        |
| Gain on disposal of marketable securities   |                             |             | (160)       |
| Impairment loss on goodwill   | 317                         |             |             |
| Stock-based compensation  | 310                         | 62          | 125         |
| Non-controlling interests   | 228                         |             |             |
| Deferred tax  | (551)                       | (517)       | 1,016       |
| Changes in operating assets and liabilities:                                      |                             |             |             |
| Accounts receivable   | (334)                       | (918)       | 7,828       |
| Inventories   | 3,033                       | 4,923       | 5,637       |
| Prepaid expenses and other current assets   | (345)                       | 1,306       | 287         |
| Income taxes receivable   | 127                         | 3           |             |
| Accounts payable  | (3,338)                     | (2,157)     | (3,072)     |
| Accrued payroll and employee benefits   | 23                          | (376)       | 97          |
| Customer deposits   | 342                         | 335         | (577)       |
| Other accrued liabilities   | 594                         | 67          | (262)       |
| Income taxes payable  | 179                         | 74          | (705)       |
| Net cash provided by operating activities   | 16,418                      | 11,669      | 14,351      |
| Cash flows from investing activities  |                             |             |             |
| Purchase of property, plant and equipment   | (7,288)                     | (7,402)     | (1,606)     |
| Acquisition of non-controlling interest in a subsidiary                           | (414)                       |             |             |
| Proceeds from sale of property, plant and equipment, net of transaction costs     | 333                         | 345         | 5,528       |
| Purchase of marketable securities   |                             |             | (5,631)     |
| Proceeds from sale of marketable securities                                       |                             |             | 260         |
| Net cash used in investing activities   | (7,369)                     | (7,057)     | (1,449)     |
| Cash flows from financing activities  |                             |             |             |
| Dividends paid  | (9,523)                     | (3,789)     | (1,619)     |
| Exercise of stock options   | 986                         |             | 703         |

|  |            |           |           |
|--|------------|-----------|-----------|
| Net cash used in financing activities  | (8,537)    | (3,789)   | (916)     |
| Effect of exchange rate changes  | (2,343)    | (407)     |           |
| Net (decrease) increase in cash and cash equivalents   | (1,831)    | 416       | 11,986    |
| Cash and cash equivalents, beginning of year   | 24,549     | 22,718    | 23,134    |
| Cash and cash equivalents, end of year   | \$ 22,718  | \$ 23,134 | \$ 35,120 |
| Supplementary disclosures of cash flow information:  |            |           |           |
| Cash paid during the year for:   |            |           |           |
| Interest   | \$         | \$        | \$        |
| Income taxes   | \$ 365     | \$ 79     | \$ 380    |
| Supplementary disclosures of significant non-cash transactions:  |            |           |           |
| Issuance of common stock in connection with acquisition of additional 24% shareholding in a subsidiary           | \$ 6,342   | \$        | \$        |
| Excess of acquisition cost over the fair value of acquired net assets of additional shareholding of a subsidiary | \$ (1,314) | \$        | \$        |

See accompanying notes to consolidated financial statements.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**1. Organization and Basis of Financial Statements**

Deswell Industries, Inc. was incorporated in the British Virgin Islands on December 2, 1993.

The principal activities of the Company comprise the manufacture and sale of injection-molded plastic parts and components, electronic products assembling and metallic parts manufacturing. The manufacturing activities are subcontracted to subsidiaries operating in Mainland China. The selling and administrative activities were originally performed in the Hong Kong Special Administrative Region ( Hong Kong ) of the People's Republic of China ( China ). From August 2003, these activities were moved to the Macao Special Administrative Region ( Macao ) of China.

As the Company is a holding company, the amount of any dividends to be declared by the Company will be dependent upon the amount which can be distributed from its subsidiaries. Dividends from subsidiaries are declared based on profits as reported in their statutory accounts. Such profits differ from the amounts reported under U.S. GAAP. At March 31, 2010, the retained earnings available for distribution as reflected in the statutory books of the subsidiaries were \$54,100.

On January 20, 2003, the Company acquired a further 20% of the outstanding stock of Integrated International Limited ( Integrated ), a subsidiary of the Company, from the minority shareholders. After the acquisition, the Company increased its ownership in Integrated to 71% of the outstanding stock. The purchase consideration for the 20% of the outstanding stock of Integrated was 251,880 common shares of the Company. The value of the purchase consideration was based on the market price of the stocks issued which was lower than the fair value of net assets acquired by \$115. The excess was allocated as a pro rata reduction of the amounts that would have been assigned to certain acquired assets.

On April 20, 2005, the Company acquired a further 5% of the outstanding stock from one of the minority shareholders of Integrated. After the acquisition, the Company increased its ownership in Integrated to 76% of the outstanding stock. The purchase consideration for the 5% of the outstanding stock of Integrated was 120,000 common shares of the Company. The value of the purchase consideration was based on the market price of the stocks issued which was higher than the fair value of net assets acquired by \$232. The excess purchase price was recorded on the balance sheet as goodwill.

On August 17, 2007, the Company acquired the remaining 24% of the outstanding stock from minority shareholders of Integrated. After the acquisition, the Company increased its ownership in Integrated to 100% of the outstanding stock. The aggregate purchase consideration for the 24% of the outstanding stock of Integrated is 632,080 common shares of the Company and a cash payment of \$414. The value of the purchase consideration was based on the market price of the shares issued and the cash payment, which was lower than the fair value of net assets acquired by \$1,314. The excess was allocated as a pro-rata reduction of the amounts that would have been assigned to certain acquired assets.

On March 24, 2010, the Company deregistered a fully owned subsidiary, Jetcrown Industrial (Shenzhen) Limited ( JISL ).

**2. Summary of Significant Accounting Policies**

*Principles of consolidation* The consolidated financial statements, prepared in accordance with generally accepted accounting principles in the United States of America, include the assets, liabilities, revenues, expenses and cash flows of all subsidiaries. Intercompany balances, transactions and cash flows are eliminated on consolidation.

*Goodwill* The excess purchase price over the fair value of net assets acquired is recorded on the balance sheet as goodwill. The Company adopted Accounting Standards Codification ( ASC ) No. 350, Intangibles—Goodwill and Other (formerly the Statement of Financial Accounting Standards ( SFAS ) No. 142—Goodwill and other Intangible Assets ), which requires the carrying value of goodwill to be evaluated for impairment on an annual basis. The Company regularly conducted annual impairment evaluation.

*Cash and cash equivalents* Cash and cash equivalents include cash on hand, cash accounts, interest bearing savings accounts and time certificates of deposit with a maturity of three months or less when purchased.

*Marketable securities* All marketable securities are classified as trading securities and are stated at fair market value. Market value is determined by the most recently traded price of the security at the balance sheet date. Net realized and unrealized gains and losses on trading securities are included in non-operating income. The cost of investments sold is based on the average cost method and interest earned is included in non-operating income.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**2. Summary of Significant Accounting Policies continued**

*Inventories* Inventories are stated at the lower of cost or market value. Cost is determined on the weighted average basis. Work-in-progress and finished goods inventories consist of raw materials, direct labour and overhead associated with the manufacturing process. Write down of potentially obsolete or slow-moving inventory are recorded based on management's analysis of inventory levels.

*Property, plant and equipment* Property, plant and equipment is stated at cost including the cost of improvements. Maintenance and repairs are charged to expense as incurred. Depreciation and amortization are provided on the straight line method based on the estimated useful lives of the assets as follows:

|                                   |  |
|-----------------------------------|--|
| Leasehold land and buildings      | 40 - 50 years                            |
| Plant and machinery               | 4 - 10 years                             |
| Furniture, fixtures and equipment | 4 - 5 years                              |
| Motor vehicles                    | 3 - 4 years                              |
| Leasehold improvements            | the shorter of 5 years or the lease term |

*Leases* Leases are classified at the inception date as either a capital lease or an operating lease. For the lessee, a lease is a capital lease if any of the following conditions exist: a) ownership is transferred to the lessee by the end of the lease term, b) there is a bargain purchase option, c) the lease term is at least 75% of the property's estimated remaining economic life or d) the present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date. A capital lease is accounted for as if there was an acquisition of an asset and an incurrence of an obligation at the inception of the lease. All other leases are accounted for as operating leases. The Company has no capital leases for any of the periods presented.

*Valuation of long-lived assets* The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other intangible assets subject to amortization, when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flow from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the long-lived asset. Fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on long-lived assets to be disposed of are determined in a similar manner, except that fair market values are reduced for the cost to dispose.

*Revenue recognition* Sales of goods are recognized when goods are shipped, title of goods sold has passed to the purchaser, the price is fixed or determinable as stated on the sales contract, and its collectability is reasonably assured. Customers do not have a general right of return on products shipped. The Company permits the return of damaged or defective products and accounts for these returns as deduction from sales. Products returns to the Company were insignificant during past years.

*Comprehensive income* - Other comprehensive income for the years ended March 31, 2008, 2009 and 2010 represented foreign currency translation adjustments and were included in the consolidated statement of income.

*Allowance for doubtful account* The Company regularly monitors and assesses the risk of not collecting amounts owed to the Company by customers. This evaluation is based upon a variety of factors including: ongoing credit evaluations of its customers' financial condition, an analysis of amounts current and past due along with relevant history and facts particular to the customer. Based upon the results of this analysis, the Company records an allowance for uncollectible accounts for this risk. This analysis requires the Company to make significant estimates, and changes in facts and circumstances could result in material changes in the allowance for doubtful accounts. Unanticipated changes in the liquidity or financial position of the Company's customers may require additional provisions for doubtful accounts.

*Shipping and handling cost-* Shipping and handling costs related to the delivery of finished goods are included in selling expenses. During the years ended March 31, 2008, 2009 and 2010, shipping and handling costs expensed to selling expenses were \$1,005, \$1,714 and \$985, respectively.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**2. Summary of Significant Accounting Policies continued**

*Income taxes* Income taxes are provided on an asset and liability approach for financial accounting and reporting of income taxes. Any China tax paid by subsidiaries during the year is recorded. Deferred income taxes are recognized for all significant temporary differences at enacted rates and classified as current or non-current based upon the classification of the related asset or liability in the financial statements. A valuation allowance is provided to reduce the amount of deferred tax assets if it is considered more likely than not that some portion of, or all, the deferred tax asset will not be realized. The Company classifies interest and/or penalties related to unrecognized tax benefits, if any, as a component of income tax provisions.

The Company adopted the provisions of ASC No. 740 *Income Taxes* (ASC 740) (formerly the FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109), which clarifies the accounting for uncertainty in income taxes recognized by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides accounting guidance on de-recognition, classification, interest and penalties, disclosure and transition.

*Foreign currency translation* The consolidated financial statements of the Company are presented in U.S. dollars as the Company is incorporated in the British Virgin Islands where the currency is the U.S. dollar. The Company's subsidiaries conduct substantially all of their business in Hong Kong dollars, Chinese renminbi or U.S. dollars. The exchange rates between the Hong Kong dollars and the U.S. dollar were approximately 7.782, 7.7597 and 7.7597 as of March 31, 2008, 2009 and 2010, respectively. The exchange rates between the Chinese renminbi and the U.S. dollar were approximately 7.1076, 6.8417 and 6.8417 as of March 31, 2008, 2009, and 2010, respectively.

All transactions in currencies other than functional currencies during the year are translated at the exchange rates prevailing on the transaction dates. Monetary items existing at the balance sheet date denominated in currencies other than the functional currencies are translated at period end rates. Gains and losses resulting from the translation of foreign currency transactions and balances are included in income.

Aggregate net foreign currency transaction gain(loss) included in other income were \$2,047, \$704 and (\$43) for the years ended March 31, 2008, 2009 and 2010, respectively.

Prior to January 1, 2009, the functional currencies of our subsidiaries were Hong Kong dollars and Chinese renminbi. Effective January 1, 2009, the functional currencies of all our subsidiaries were changed to U.S. dollars. The U.S. dollar is considered by management to be the most appropriate functional currency of Deswell's subsidiaries because over the years, and especially in our year ended March 31, 2009, most of our customers contracted with our subsidiaries in U.S. dollars.

During the years ended March 31, 2009 and 2010, 72.4% and 62.7% of our sales of plastic products were denominated in U.S. dollars, respectively. During the years ended March 31, 2009 and 2010, 95% and 95%, respectively, of sales of products in our electronics segment were denominated in U.S. dollars.

Primarily because of the stability of the exchange rate between the Hong Kong dollar and the U.S. dollar, which has existed since the Hong Kong government pegged the exchange rate at HK\$7.80 to US\$1.00 in 1983, and, to a lesser degree, because of the reversal of the trend of appreciation of the Chinese Renminbi to the U.S. dollar, beginning around July 1, 2008, and the relative stability in the exchange rate of the Chinese Renminbi to the U.S. dollar since then, the actual effect of the change in our functional currency to the U.S. dollar was immaterial to our results of operations, liquidity and cash flows for our years ended March 31, 2009 and March 31, 2010.

Irrespective of our functional currency, however, if the exchange rate of the Chinese Renminbi to U.S. dollar again becomes volatile, our results of operations would be affected, positively or negatively, depending on the amounts of expenses our subsidiaries pay in Chinese Renminbi and whether the Chinese Renminbi depreciates or appreciates to the U.S. dollar. In view of the current global economic recession, we cannot predict whether the relative stability in the currency exchange rate of the Chinese Renminbi to the U.S. dollar experienced during 2009, and which has continued so far into 2010, can be expected to continue following an economic recovery. In any event, if the Chinese

Renminbi resumes appreciating to the U.S. dollar, our operating costs would increase and our financial results would be adversely affected.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**2. Summary of Significant Accounting Policies continued**

*Post-retirement and post-employment benefits* The Company and its subsidiaries contribute to a state pension scheme in respect of its Chinese employees.

*Stock-based compensation* The Company adopts ASC No. 718, Compensation Stock Compensation (formerly the SFAS No. 123 (revised 2004) Share-based Payment ), which requires that share-based payment transactions with employees, such as share options, be measured based on the grant-date fair value of the equity instrument issued and recognized as compensation expense over the requisite service period, with a corresponding addition to equity. Under this method, compensation cost related to employee share options or similar equity instruments is measured at the grant date based on the fair value of the award and is recognized over the period during which an employee is required to provide service in exchange for the award, which generally is the vesting period.

For the years ended March 31, 2008, 2009 and 2010, the Company records stock-based compensation expenses amounted to \$310, \$62 and \$125 in the statement of income respectively. There is no tax benefit recognized in relation to the stock-based compensation expenses incurred for the three years.

The fair value of options granted in the years ended March 31, 2008, 2009 and 2010 were estimated using the Binomial option pricing model with the following assumptions:

|   | <b>2008</b> | <b>2009</b> | <b>2010</b> |
|---|-------------|-------------|-------------|
| Risk-free interest rate weighted average  | 3.63%       | 2.90%       | 2.88%       |
| Expected life of options weighted average | 10 years    | 10 years    | 10 years    |
| Stock volatility                          | 41.28%      | 40.49%      | 47.08%      |
| Expected dividend yield                   | 5.04%       | 7.35%       | 6.61%       |

The Company applied judgment in estimating key assumptions in determining the fair value of the stock options on the date of grant. The Company used historical data to estimate the expected life of options, stock volatility and expected dividend yield. The risk-free interest rate of the option was based on the 10 years U.S. Treasury yield at time of grant.

*Net income per share* Basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per share gives effect to all dilutive potential common shares outstanding during the period. The weighted average number of common shares outstanding is adjusted to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In computing the dilutive effect of potential common shares, the average stock price for the period is used in determining the number of treasury shares assumed to be purchased with the proceeds from the exercise of options.

Basic net income per share and diluted net income per share calculated in accordance with ASC No. 260, Earnings Per Share (formerly the SFAS No. 128, Earnings Per Share ), are reconciled as follows (shares in thousands):

|   | <b>Year ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Net income attributable to Deswell Industries, Inc. | \$ 8,859                    | \$ 1,195    | \$ 1,499    |
| Basic net income per share                          | \$ 0.57                     | \$ 0.08     | \$ 0.09     |
| Basic weighted average common shares outstanding    | 15,517                      | 15,791      | 15,965      |
| Effect of dilutive securities Options               | 39                          | 14          | 74          |

|   |         |         |         |
|---|---------|---------|---------|
| Diluted weighted average common and potential common shares outstanding | 15,556  | 15,805  | 16,039  |
| Diluted net income per share  | \$ 0.57 | \$ 0.08 | \$ 0.09 |

For the years ended March 31, 2008, 2009 and 2010, potential common shares of 644,000, 726,000 and 668,500 shares related to stock options are excluded from the computation of diluted net income per share as their exercise prices were higher than the average market price.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**2. Summary of Significant Accounting Policies continued**

*Use of estimates* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Fair value of financial instruments* The fair value of a financial instrument is defined as the exchange price that would be received from an asset or paid to transfer a liability (as exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. The carrying amounts of financial assets and liabilities, such as cash, accounts receivable, prepaid expenses and other current assets, accounts payable, and other current liabilities, approximate their fair values because of the short maturity of these instruments and market rates of interest.

*Fair Value Measurements* The Company has adopted ASC Topic 820, Fair Value Measurements and Disclosures, (formerly the SFAS No.157, Fair Value Measurements ) which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. It does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information.

Its establishes a three-level valuation hierarchy of valuation techniques based on observable and unobservable inputs, which may be used to measure fair value and include the following:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Classification within the hierarchy is determined based on the lowest level of input that is significant to the fair value measurement.

*Recent changes in accounting standards* In June 2009, the FASB issued ASU No. 860-20, Sale of Financial Assets ( ASU 860-20 ) (formerly the SFAS No. 166 Accounting for Transfers of Financial Assets ). This statement is intended to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement in transferred financial assets. This Statement must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, and is required to be adopted by the Company in the first quarter of fiscal year 2011. Earlier application is prohibited. This Statement must be applied to transfers occurring on or after the effective date. The adoption of ASU 860-20 is not expected to materially impact on the Company's financial position, results of operations and cash flows.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements ( ASU 2010-06 ). ASU 2010-06 requires new disclosures and clarifies existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. ASU 2010-06 amends Codification Subtopic 820-10 to now require that (1) a reporting entity must disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; (2) in the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements and (3) a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and

settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company is currently evaluating the impact of ASU 2010-06 on the Company's financial position, results of operations and cash flows, but does not expect it to have a material impact.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**3. Marketable Securities**

The Company acquired equity securities listed in Hong Kong.

|              | <b>March 31,</b> |             |
|--------------|------------------|-------------|
|              | <b>2009</b>      | <b>2010</b> |
| Cost         | \$297            | \$5,631     |
| Market value | \$100            | \$5,673     |

Unrealized gain (loss) for the years ended March 31, 2008, 2009 and 2010 were \$9, (\$16) and \$42, respectively.

Net proceeds from sale of marketable securities for the years ended March 31, 2008, 2009 and 2010 were \$nil, \$nil and \$260, respectively and realized gain from sale of marketable securities for the years ended March 31, 2008, 2009 and 2010 were \$nil, \$nil and \$160 respectively. For the purposes of determining realized gains and losses, the cost of securities sold was determined based on the average cost method.

The marketable securities were classified as Level 1 of the hierarchy established under ASU 2010-06 because the valuations were based on quoted prices for identical securities in active markets.

**4. Inventories**

Inventories by major categories are summarized as follows:

|                  | <b>March 31,</b> |             |
|------------------|------------------|-------------|
|                  | <b>2009</b>      | <b>2010</b> |
| Raw materials    | \$11,930         | \$10,162    |
| Work in progress | 4,941            | 2,938       |
| Finished goods   | 4,574            | 2,708       |
|                  | \$21,445         | \$15,808    |

**5. Prepaid Expenses and Other Current Assets**

Prepaid expenses and other current assets consist of the following:

|   | <b>March 31,</b> |             |
|---|------------------|-------------|
|   | <b>2009</b>      | <b>2010</b> |
| Value added tax receivable                  | \$ 886           | \$ 749      |
| Deposit for purchase of plant and equipment | 249              |             |
| Rental and utility deposit                  | 50               | 181         |
| Advance to suppliers                        | 182              | 458         |
| Prepayment                                  | 443              | 81          |
| Others                                      | 77               | 375         |

\$1,887

\$1,844

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**6. Property, Plant and Equipment**

Property, plant and equipment consist of the following:

|   | <b>March 31,</b> |               |
|---|------------------|---------------|
|   | <b>2009</b>      | <b>2010</b>   |
| At cost:  |                  |               |
| Land and buildings                              | \$ 34,700        | \$ 34,895     |
| Plant and machinery                             | 40,617           | 41,726        |
| Furniture, fixtures and equipment               | 24,414           | 24,551        |
| Motor vehicles                                  | 2,263            | 1,903         |
| Leasehold improvements                          | 4,767            | 4,616         |
| <br>Total                                       | <br>106,761      | <br>107,691   |
| Less: accumulated depreciation and amortization | (41,632)         | (47,152)      |
| Less: impairment                                | (61)             | (69)          |
|   | <br>65,068       | <br>60,470    |
| <br>Construction in progress                    | <br>1,611        | <br>315       |
| Less: impairment                                | (115)            | (80)          |
|   | <br>1,496        | <br>235       |
| <br>Net book value                              | <br>\$ 66,564    | <br>\$ 60,705 |

Cost of land and buildings consist of the following:

|  | <b>March 31,</b> |              |
|--|------------------|--------------|
|  | <b>2009</b>      | <b>2010</b>  |
| Land use right of state-owned land and buildings erected thereon (a) | \$30,532         | \$30,727     |
| Long term leased land and buildings erected thereon (b)              | 4,168            | 4,168        |
|  | <br>\$34,700     | <br>\$34,895 |

(a) The land use rights of state-owned land and buildings erected thereon represent land and buildings located in

China with lease terms of 50 years expiring in 2050.

- (b) Long term leased land and buildings erected thereon represent land and buildings on collectively-owned land located in China on which an upfront lump-sum payment has been made for the right to use the land and building for a term of 50 years to 2053. Dongguan Chang An Xiaobian District Co-operation, the lessor, is the entity to whom the collectively-owned land has been granted. According to existing China laws and regulations, collectively-owned land is not freely transferable unless certain application and approval procedures are fulfilled by the Dongguan Chang An Xiaobian District Co-operation to change the legal form of the land from collectively-owned to state-owned. As of March 31, 2010, the Company is not aware of any steps being taken by the Dongguan Chang

An Xiaobian  
District  
Co-operation for  
such application.

During the year, the Company disposed of the old plastic injection factory premises located in Shenzhen, China with a net gain of \$4,198 which included in other income. These premises were classified as assets held for sale under current assets at March 31, 2009.

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**DESWELL INDUSTRIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(U.S. dollars in thousands, except per share data)**

**7. Goodwill**

The impairment in goodwill for the years ended March 31, 2008, 2009 and 2010 were \$317, \$nil and \$nil, respectively. Details of the goodwill are as follows:

## Acquisitions

|                              | <b>March 31,</b> |               |
|------------------------------|------------------|---------------|
|                              | <b>2009</b>      | <b>2010</b>   |
| Electronic division          | \$ 393           | \$ 393        |
| Metallic division            | 317              | 317           |
| Foreign exchange differences | (1)              | (1)           |
| Impairment metallic division | (317)            | (317)         |
|                              | <b>\$ 392</b>    | <b>\$ 392</b> |

**8. Other Accrued Liabilities**

Other accrued liabilities consist of the following:

|                         | <b>March 31,</b> |                |
|-------------------------|------------------|----------------|
|                         | <b>2009</b>      | <b>2010</b>    |
| Accrued expenses        | \$1,164          | \$1,242        |
| Commission expenses     | 239              | 91             |
| Value added tax payable | 53               | 49             |
| Others                  | 711              | 523            |
|                         | <b>\$2,167</b>   | <b>\$1,905</b> |

**9. Income Taxes**

The components of income before income taxes are as follows:

|           | <b>Year ended March 31,</b> |              |                |
|-----------|-----------------------------|--------------|----------------|
|           | <b>2008</b>                 | <b>2009</b>  | <b>2010</b>    |
| Hong Kong | \$ (1)                      | \$ (5)       | \$ (1)         |
| China     | 9,192                       | 918          | 2,190          |
|           | <b>\$9,191</b>              | <b>\$913</b> | <b>\$2,189</b> |

Under the current BVI law, the Company's income is not subject to taxation. Subsidiaries operating in Hong Kong and China are subject to income taxes as described below, and the subsidiaries operating in Macao are exempted from income taxes. Under the current Samoa Law, subsidiaries incorporated in Samoa are not subject to profit tax as they have no business operations in Samoa.

The provision for current income taxes of the subsidiaries operating in Hong Kong has been calculated by applying the current rate of taxation of 16.5% (2008:17.5%, 2009:16.5%) to the estimated taxable income arising in or derived from Hong Kong, if applicable.

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**DESWELL INDUSTRIES, INC.**  
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**(U.S. dollars in thousands, except per share data)**

**9. Income Taxes continued**

Prior to January 1, 2008, enterprise income tax in China was generally charged at 33%, in which 30% is for national tax and 3% is for local tax, of the assessable profit. For foreign investment enterprises established in a Special Economic Zone or Coastal Open Economic Zone, where the subsidiaries of the Company are located, and which are engaged in production-oriented activities, the national tax rate could be reduced to 15% and 24% respectively. The Company's subsidiaries incorporated in China are subject to China income taxes at the applicable tax rates on the taxable income as reported in their Chinese statutory accounts in accordance with the relevant income tax laws applicable to foreign enterprises. Pursuant to the PRC income tax laws, the subsidiaries are fully exempted from China income tax for two years starting from the first profit-making year, followed by a 50% tax exemption for the next three years.

From January 1, 2008, with the effect of the new PRC Income Tax Law, the standard income tax rate for all companies has been reduced from the rate of 33% to 25%.

JISL, a fully owned subsidiary deregistered on March 24, 2010, had fully enjoyed the above tax holiday and concessions by December 31, 1995. The applicable tax rate for the calendar year ended December, 2007 was 15%. Under the new Income Tax Law, the tax rate applicable to JISL is 18% and 20% for the years ended December 31, 2008 and 2009, respectively.

Dongguan Kwan Hong Electronics Company Limited ( DKHE ) (a subsidiary of the Company) had fully enjoyed the tax holiday and concessions by December 31, 2004. DKHE was approved as a High-tech Enterprise by the tax authority and enjoyed a national tax rate of 15%. For the calendar year ended December 31, 2006, DKHE was approved as an Export-oriented Enterprises by the local tax authority and enjoyed a lower tax rate of 10%. For the calendar year ended December 31, 2007, the tax rate for DKHE as a High-tech Enterprise was 18%, in which 15% is for national tax and 3% is for the local tax. For the calendar year ended December 31, 2008, as there is no more reduction in the tax rate for foreign investment enterprise which exports 70% or more of the production value to their products (known as Export-oriented Enterprise) under the new Income Tax Law, the applicable tax rate of DKHE for the calendar years ended December 31, 2008 and 2009 is 25%.

In September 2007, Jetcrown Industrial (Dongguan) Limited ( JIDL ) (a subsidiary of the Company) had revised its first and second tax exemption year from the calendar year ended December 31, 2004 and 2005 respectively, to the calendar years ended December 31, 2002 and 2003 respectively. The revision was upon a tax reassessment by the PRC Tax Bureau during the year ended March 31, 2007 regarding the commencement year of exemption and inter-company sales pricing issues. The tax rate applicable for JIDL for calendar years 2002 to 2006 was 24%. JIDL was entitled to a full tax exemption for each of the calendar years ended December 31, 2002 and 2003 and a 50% exemption for each of the calendar years ended December 31, 2004, 2005 and 2006. An aggregate amount of \$450 additional income tax provision, which comprised approximately \$154, \$92, \$166 and \$38 for taxable calendar years 2004, 2005 and 2006 and the quarter ended March 31, 2007 respectively had been charged to the consolidation income statement for the year ended March 31, 2007. The assessment and payment for income taxes for calendar years 2004 and 2005 were settled and concluded in September 2007 at the amount as provided. The assessment and payment for calendar year 2006 were settled at \$101 in January 2008. However, there can be no assurance that the PRC Tax Bureau will not, in the future, further challenge (i) the reported revenue of JIDL for periods starting from the calendar year ended 31 December 2006; and (ii) revenues reported by JIDL for value-added tax filing purpose. There can also be no assurance that similar reassessments will not be extended to other PRC subsidiaries of the Company. The above reassessments, if conducted in the future, may cause an adverse impact to the net operating results of the Company.

For the calendar year ended December 31, 2007, JIDL was approved as an Export-oriented Enterprises by the local tax authority and enjoyed a lower tax rate of 12%. For the calendar year ended December 31, 2008 and 2009, the tax rate for JIDL is 25%, being the unified tax rate under the New Tax Law effective from January 1, 2008.

Had the all above tax holidays and concessions not been available, the tax charge would have been higher by \$89, \$nil and \$nil and the basic net income per share would have been lower by \$0.01, \$nil and \$nil for the years ended March 31, 2008, 2009 and 2010 respectively, and diluted net income per share for the years ended March 31, 2008, 2009 and 2010 would have been lower by \$0.01, \$nil and \$nil, respectively.

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**DESWELL INDUSTRIES, INC.**  
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**(U.S. dollars in thousands, except per share data)**

**9. Income Taxes continued**

The Company has adopted the provisions of ASC 740 on April 1, 2007. The evaluation of a tax position in accordance with ASC 740 begins with a determination as to whether it is more-likely-than-not that a tax position will be sustained upon examination based on the technical merits of the position. A tax position that meets the more-likely-than-not recognition threshold is then measured at the largest amount of benefit that if greater than 50 percent likely of being realized upon ultimate settlement for recognition in the financial statements. There is no material impact on the adoption of ASC 740. The Company classifies interest and/or penalties related to unrecognized tax benefits as a component of income tax provisions; however, as of March 31, 2010, there is no interest and penalties related to uncertain tax positions, and the Company has no material unrecognized tax benefit which would favorably affect the effective income tax rate in future periods. The Company does not anticipate any significant increases or decreases to its liability for unrecognized tax benefit within the next twelve months. The provision for income taxes consists of the following:

|              | <b>Year ended March 31,</b> |             |             |
|--------------|-----------------------------|-------------|-------------|
|              | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Current tax  |                             |             |             |
| - China      | \$ 654                      | \$ 234      | \$380       |
| Deferred tax | (550)                       | (516)       | 310         |
|              | \$ 104                      | \$(282)     | \$690       |

A reconciliation between the provision for income taxes computed by applying the statutory tax rate in China to income before income taxes and the actual provision for income taxes is as follows:

|   | <b>Year ended March 31,</b> |             |             |
|---|-----------------------------|-------------|-------------|
|   | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Provision for income taxes at statutory tax rate in China | \$ 2,988                    | \$ 227      | \$ 547      |
| Effect of different tax rate in various jurisdictions     |                             | (1)         | (210)       |
| Tax holidays and concessions                              | (89)                        |             |             |
| Effect of income for which no income tax is chargeable    | (3,435)                     | (1,452)     | (212)       |
| Effect of expense for which no income tax is deductible   | 231                         | 1,307       | 847         |
| Net change in valuation allowances                        | (16)                        | (15)        | (233)       |
| Under (over) provision of income tax in previous years    | 477                         | (348)       | (69)        |
| Others  | (52)                        |             | 20          |
| Effective tax   | \$ 104                      | \$ (282)    | \$ 690      |

The components of deferred income tax are as follows:

**March 31,**  
**2009**                      **2010**



|  |        |          |
|--|--------|----------|
| Deferred tax asset (liability) :   |        |          |
| Net operating loss carry forwards  | \$ 550 | \$ 704   |
| Provision of employee benefits   | 308    | 242      |
| Depreciation and amortization  | 93     | 26       |
| Revenue recognized for financial reporting purpose before being recognized for tax purpose |        | (1,285)  |
| Others   | 28     | 43       |
| Less: Valuation allowances   | (233)  |          |
| Net deferred tax asset (liability)   | \$ 746 | \$ (270) |

A significant portion of the deferred tax assets recognized relates to net operating loss and credit carry forwards. The Company operates through the PRC entities and the valuation allowance is considered on each individual basis.

The net operating loss attributable to those PRC entities can only be carried forward for a maximum period of five years. Tax losses of non-PRC entities can be carried forward indefinitely. The unused tax losses, amounted to \$1,188, \$118 and \$1,510, will be expired in calendar year ending 2012, 2013 and 2014 respectively.

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**DESWELL INDUSTRIES, INC.**  
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**10. Commitments and Contingencies**

The Company leases premises under various operating leases, certain of which contain escalation clauses. Rental expenses under operating leases included in the statement of income were \$265, \$317 and \$216 for the years ended March 31, 2008, 2009 and 2010, respectively.

At March 31, 2010, the Company was obligated under operating leases requiring minimum rentals as follows:  
Years ending March 31

|                              |       |
|------------------------------|-------|
| 2011                         | \$ 29 |
| Total minimum lease payments | \$ 29 |

At March 31, 2010, the Company had capital commitments for purchase of plant and machinery totaling \$73, which are expected to be disbursed during the year ending March 31, 2011. The Company had capital commitments for system upgrade project at March 31, 2010 totaling \$191, which are expected to be disbursed by March 31, 2011. The company also had capital commitments for leasehold improvements totaling \$20, which are expected to be disbursed during the year ending March 31, 2011.

**11. Employee Benefits**

The Company contributes to a state pension scheme run by the Chinese government in respect of its employees in China. The expense of \$817, \$697 and \$528 related to this plan, which is calculated at the range of 8% to 11% of the average monthly salary, was provided for the years ended March 31, 2008, 2009 and 2010, respectively.

**12. Stock Option Plan**

On March 15, 1995, the Company adopted 1995 Stock Option Plan that permits the Company to grant options to officers, directors, employees and others to purchase up to 1,012,500 shares of Common Stock. On September 29, 1997, the Company approved an increase of 549,000 shares making a total of 1,561,500 shares of common stock available under the stock option plan. On January 7, 2002, the Company adopted 2001 Stock Option Plan to purchase an additional 1,125,000 shares of Common Stock. On September 30, 2003, the Company adopted 2003 Stock Option Plan to purchase an additional 900,000 shares of Common Stock. On September 19, 2005, the Company approved an increase of 500,000 shares making a total of 1,400,000 shares of common stock available under the 2003 Stock Option Plan. On August 17, 2007, the Company approved an increase of 400,000 shares making a total of 1,800,000 shares of common stock available under the 2003 Stock Option Plan.

At March 31, 2010, options to purchase an aggregate of 4,269,000 common shares had been granted under the stock option plans. Options granted under the stock option plans will be exercisable for a period of up to 10 years commencing on the date of grant, at a price equal to at least the fair market value of the Common Stock at the date of grant, and may contain such other terms as the Board of Directors or a committee appointed to administer the plan may determine. All the options expire 10 years from the date of grant and vest immediately or over a period of 1 to 10 years. A summary of the option activity (with weighted average prices per share) is as follows:

|  | 2008                          |  | Year ended March 31,<br>2009  |  | 2010                          |  |
|--|-------------------------------|--|-------------------------------|--|-------------------------------|--|
|  | Number<br>of stock<br>options | Weighted<br>average<br>exercise<br>price | Number<br>of stock<br>options | Weighted<br>average<br>exercise<br>price | Number<br>of stock<br>options | Weighted<br>average<br>exercise<br>price |
|  | 1,029,000                     | \$ 11.91                                 | 1,119,000                     | \$ 11.14                                 | 1,066,000                     | \$ 9.19                                  |

|  |                   |          |                   |         |                   |          |
|--|-------------------|----------|-------------------|---------|-------------------|----------|
| Outstanding at beginning of the year               |                   |          |                   |         |                   |          |
| Granted during the year                            | 210,000           | 5.71     | 190,000           | 1.34    | 233,000           | 2.09     |
| Exercised during the year                          | (120,000)         | 8.26     |                   |         | (401,000)         | 1.75     |
| Canceled or expired                                |                   |          | (243,000)         | 12.03   | (207,500)         | 12.27    |
| Outstanding and exercisable at the end of the year | 1,119,000         | \$ 11.14 | 1,066,000         | \$ 9.19 | 690,500           | \$ 10.19 |
| Range of exercise price per share                  | \$5.71 to \$14.10 |          | \$1.34 to \$14.10 |         | \$1.34 to \$14.10 |          |

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**DESWELL INDUSTRIES, INC.**  
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**(U.S. dollars in thousands, except per share data)**

**12. Stock Option Plan continued**

The weighted average fair value of options granted for the year ended March 31, 2008, 2009 and 2010 was \$1.48, \$0.33 and \$0.54 per share, respectively. The total intrinsic value of options exercised during the years ended March 31, 2008, 2009 and 2010 was \$433, \$nil and \$940, respectively. At March 31, 2010, the aggregated intrinsic value of options outstanding and exercisable was \$54.

There were nil, 243,000 and 207,500 options canceled for the years ended March 31, 2008, 2009 and 2010. The weighted average remaining contractual life of the share options outstanding at March 31, 2010 was 5.40 years. At March 31, 2008, 2009 and 2010, there were 190,000, 243,000 and 217,500 options available for future grant under the plans respectively.

**13. Operating Risk**

*Concentrations of Credit Risk and Major Customers* A substantial percentage of the Company's sales are made to a small number of customers and are typically sold either under letter of credit or on an open account basis. Details of customers accounting for 10% or more of total net sales for each of the three years ended March 31, 2008, 2009 and 2010 are as follows:

|                                  | <b>Percentage of net sales</b> |             |             |
|----------------------------------|--------------------------------|-------------|-------------|
|                                  | <b>Year ended March 31,</b>    |             |             |
|                                  | <b>2008</b>                    | <b>2009</b> | <b>2010</b> |
| N&J Company Limited              | 11.8%                          | 28.6%       | 19.2%       |
| Digidesign, Inc.                 | 17.0%                          | 12.7%       | 12.0%       |
| VTech Telecommunications Limited | *                              | *           | 10.8%       |
| Inter-Tel Incorporated           | 10.2%                          | *           | *           |
| Line 6 Manufacturing             | 14.3%                          | *           | *           |

\* Less than 10%

Sales to the above customers relate to both injection-molded plastic parts and electronic products.

Accounts receivable from the five customers with the highest recorded receivable balances at March 31, 2009 and 2010, respectively, are as follows:

|   | <b>Percentage of</b> |             |
|---|----------------------|-------------|
|   | <b>accounts</b>      |             |
|   | <b>receivable</b>    |             |
|   | <b>March 31,</b>     |             |
|   | <b>2009</b>          | <b>2010</b> |
| Largest receivable balances from the five customers | 61.0%                | 47.6%       |

There were bad debt expense of \$60, \$6 and \$7 during the years ended March 31, 2008 and 2009 and 2010 respectively. There were provision for bad debts expenses of \$17, \$275 and \$72 during the years ended March 31, 2008, 2009 and 2010 respectively. There were allowances for doubtful receivables written off of \$1,173, \$nil and \$199 during the years ended March 31, 2008, 2009 and 2010 respectively.

*Country risk* The Company has significant investments in China. The operating results of the Company may be adversely affected by changes in the political and social conditions in China, and by changes in Chinese government policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad,

and rates and methods taxation, among other things. There can be no assurance, however, those changes in political and other conditions will not result in any adverse impact.

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**DESWELL INDUSTRIES, INC.**  
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**(U.S. dollars in thousands, except per share data)**

**14. Segment Information**

The Company has three reportable segments: plastic injection molding, electronic products assembling and metallic parts manufacturing. The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as a unit, and the management at the time of the acquisition was retained.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company accounts for intersegment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

Contributions of the major activities, profitability information and asset information of the Company's reportable segments for the years ended March 31, 2008, 2009 and 2010 are as follows:

|   | <b>Year ended March 31,</b> |                 |                     |                   |                     |               |                  |                 |                 |
|---|-----------------------------|-----------------|---------------------|-------------------|---------------------|---------------|------------------|-----------------|-----------------|
|   | <b>2008</b>                 |                 | <b>2009</b>         |                   | <b>2010</b>         |               |                  |                 |                 |
|   | <b>Intersegment</b>         | <b>Profit</b>   | <b>Intersegment</b> | <b>Profit</b>     | <b>Intersegment</b> | <b>Profit</b> |                  |                 |                 |
|   | <b>sales</b>                | <b>Sales</b>    | <b>sales</b>        | <b>Sales</b>      | <b>sales</b>        | <b>Sales</b>  |                  |                 |                 |
|   |                             | <b>(loss)</b>   |                     | <b>(loss)</b>     |                     | <b>(loss)</b> |                  |                 |                 |
| <b>Segment:</b>                               |                             |                 |                     |                   |                     |               |                  |                 |                 |
| Injection molded plastic parts                | \$ 58,858                   | \$ 28           | \$ 7,049            | \$ 75,838         | \$ 2,437            | \$ 1,553      | \$ 48,177        | \$ 1,168        | \$ 3,734        |
| Electronic products                           | 85,494                      | 3,940           | 2,412               | 57,859            | 724                 | 29            | 34,634           | 51              | (1,048)         |
| Metallic parts                                | 3,422                       |                 | (270)               | 1,202             |                     | (669)         | 36               | 14              | (497)           |
| <b>Segment total</b>                          | <b>\$ 147,774</b>           | <b>\$ 3,968</b> | <b>\$ 9,191</b>     | <b>\$ 134,899</b> | <b>\$ 3,161</b>     | <b>\$ 913</b> | <b>\$ 82,847</b> | <b>\$ 1,233</b> | <b>\$ 2,189</b> |
| <b>Reconciliation to consolidated totals:</b> |                             |                 |                     |                   |                     |               |                  |                 |                 |
| Sales eliminations                            | (3,968)                     | (3,968)         |                     | (3,161)           | (3,161)             |               | (1,233)          | (1,233)         |                 |
| <b>Consolidated totals:</b>                   |                             |                 |                     |                   |                     |               |                  |                 |                 |
| <b>Net sales</b>                              | <b>\$ 143,806</b>           | <b>\$</b>       |                     | <b>\$ 131,738</b> | <b>\$</b>           |               | <b>\$ 81,614</b> | <b>\$</b>       |                 |
| <b>Income before income taxes</b>             |                             |                 | <b>\$ 9,191</b>     |                   |                     | <b>\$ 913</b> |                  |                 | <b>\$ 2,189</b> |

|  | <b>Year ended March 31,</b> |                 |                 |                 |                 |                 |
|--|-----------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|  | <b>2008</b>                 |                 | <b>2009</b>     |                 | <b>2010</b>     |                 |
|  | <b>Interest</b>             | <b>Interest</b> | <b>Interest</b> | <b>Interest</b> | <b>Interest</b> | <b>Interest</b> |
|  | <b>income</b>               | <b>expenses</b> | <b>income</b>   | <b>expenses</b> | <b>income</b>   | <b>expenses</b> |

**Segment:**

|                                |               |           |               |           |               |           |
|--------------------------------|---------------|-----------|---------------|-----------|---------------|-----------|
| Injection molded plastic parts | \$ 458        | \$        | \$ 215        | \$        | \$ 166        | \$        |
| Electronic products            | 49            |           | 12            |           | 13            |           |
| Metallic parts                 |               |           |               |           |               |           |
| <b>Consolidated total</b>      | <b>\$ 507</b> | <b>\$</b> | <b>\$ 227</b> | <b>\$</b> | <b>\$ 179</b> | <b>\$</b> |

|   | Year ended March 31, |                 |                  |                   |                 |                  |                   |                 |                  |
|---|----------------------|-----------------|------------------|-------------------|-----------------|------------------|-------------------|-----------------|------------------|
|   | 2008                 |                 |                  | 2009              |                 |                  | 2010              |                 |                  |
|   | Identifiable         | Capital         | Depreciation     | Identifiable      | Capital         | Depreciation     | Identifiable      | Capital         | Depreciation     |
|   | assets               | expenditures    | and amortization | assets            | expenditures    | and amortization | assets            | expenditures    | and amortization |
| <b>Segment:</b>                               |                      |                 |                  |                   |                 |                  |                   |                 |                  |
| Injection molded plastic parts                | \$ 96,463            | \$ 5,050        | \$ 5,613         | \$ 101,497        | \$ 6,648        | \$ 5,834         | \$ 105,084        | \$ 1,308        | \$ 5,838         |
| Electronic products                           | 42,583               | 1,994           | 1,048            | 34,885            | 637             | 1,229            | 32,569            | 257             | 1,007            |
| Metallic parts                                | 1,540                | 244             | 279              | 1,067             | 117             | 201              | 739               | 41              | 166              |
| <b>Segment totals</b>                         | <b>\$ 140,586</b>    | <b>\$ 7,288</b> | <b>\$ 6,940</b>  | <b>\$ 137,449</b> | <b>\$ 7,402</b> | <b>\$ 7,264</b>  | <b>\$ 138,392</b> | <b>\$ 1,606</b> | <b>\$ 7,011</b>  |
| <b>Reconciliation to consolidated totals:</b> |                      |                 |                  |                   |                 |                  |                   |                 |                  |
| Elimination of receivables from intersegments | (570)                |                 |                  | (359)             |                 |                  | (4,773)           |                 |                  |
| Goodwill not allocated to segments            | 391                  |                 |                  | 392               |                 |                  | 392               |                 |                  |
| <b>Consolidated totals</b>                    | <b>\$ 140,407</b>    | <b>\$ 7,288</b> | <b>\$ 6,940</b>  | <b>\$ 137,482</b> | <b>\$ 7,402</b> | <b>\$ 7,264</b>  | <b>\$ 134,011</b> | <b>\$ 1,606</b> | <b>\$ 7,011</b>  |

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**14. Segment Information – Continued**

The Company's sales are coordinated through the Macao subsidiaries and a breakdown of sales by destination is as follows:

|                          | <b>Year ended March 31,</b> |             |             |
|--------------------------|-----------------------------|-------------|-------------|
|                          | <b>2008</b>                 | <b>2009</b> | <b>2010</b> |
| Net sales                |                             |             |             |
| United States of America | \$ 67,302                   | \$ 42,100   | \$ 36,144   |
| China                    | 53,231                      | 69,617      | 42,848      |
| United Kingdom           | 13,055                      | 13,925      | 1,278       |
| Hong Kong                | 2,486                       | 1,762       | 597         |
| Europe                   | 2,227                       | 2,438       | 364         |
| Others                   | 5,505                       | 1,896       | 383         |
| Total net sales          | \$ 143,806                  | \$ 131,738  | \$ 81,614   |

The location of the Company's identifiable assets is as follows:

|                           | <b>March 31,</b> |             |             |
|---------------------------|------------------|-------------|-------------|
|                           | <b>2008</b>      | <b>2009</b> | <b>2010</b> |
| Hong Kong and Macao       | \$ 37,800        | \$ 38,745   | \$ 52,457   |
| China                     | 102,216          | 98,345      | 81,162      |
| Total identifiable assets | \$ 140,016       | \$ 137,090  | \$ 133,619  |
| Goodwill                  | 391              | 392         | 392         |
| Total assets              | \$ 140,407       | \$ 137,482  | \$ 134,011  |

**15. Subsequent events**

On June 22, 2010, the Company declared a dividend of \$810, or \$0.05 per common share payable on July 28, 2010 to stockholders of record as of July 7, 2010.



**Table of Contents****Item 19. EXHIBITS**

The following documents are filed as exhibits herewith:

**Exhibit**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 1.1        | Memorandum and Articles of Association (as amended and restated on 13 <sup>th</sup> December, 2007 and 30 <sup>th</sup> March, 2010)  |
| 2.1        | Form of common share certificate (incorporated by reference to Exhibit 4.1 of Amendment No. 1 to Deswell's Registration Statement on Form F-1 filed with the SEC on July 13, 1995).   |
| 4.1        | 2001 Stock Option Plan (incorporated by reference to Exhibit A to the Company's Proxy Statement for its 2001 Annual Meeting of Stockholders filed with the SEC under cover of Form 6-K on December 12, 2001.)   |
| 4.2        | 2003 Stock Option Plan of Deswell Industries, Inc. (as adopted August 20, 2003 and amended August 1, 2005 and August 17, 2007) (incorporated by reference to Exhibit A to the Company's Proxy Statement filed with the Securities and Exchange Commission on Form 6-K on September 11, 2007).   |
| 4.3        | Sale and Purchase Agreement dated as of August 5, 2009 by and between Jetcrown Industrial (Shenzhen) Co., Ltd., as assignor, and an unrelated third party as assignee, to sell real property in Shekou, Shenzhen, China that was formerly used for Deswell's plastic injection molding operations for RMB 50,000,000 (approximately \$7.3 million, based on an exchange rate of 1:6.8309 on August 5, 2009 as reported on <a href="http://forex-history.net">http://forex-history.net</a> )* (incorporated by reference to Exhibit 4.3 of Deswell's Annual Report on Form 20-F for the year ended March 31, 2009 filed with the SEC on August 11, 2009) |
| 8.1        | Diagram of the Company's operating subsidiaries and affiliates (see page 19 of this report)   |
| 11.1       | Code of Ethics (incorporated by reference to Exhibit 11.1 of registrant's Form 20-F for the year ended March 31, 2004, filed with the SEC on July 16, 2004)   |
| 12.1       | Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934   |
| 12.2       | Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934   |
| 13.1       | Certification Pursuant To 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act Of 2002  |
| 14.1       | Consent of BDO Limited to incorporation of its report on the Company's consolidated financial statements into Registrant's Registration Statements on Form S-8.   |

\* The agreement is written in Chinese and an English Summary is included in

accordance with  
Form 20-F  
Instructions to  
Exhibits and  
Rule 12b-12  
(d) under the  
Exchange Act).

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**SIGNATURES**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned thereunto duly authorized.

DESWELL INDUSTRIES, INC.

By: /s/ Franki S. F. Tse  
Franki S. F. Tse,  
Chief Executive Officer

Date: July 29, 2010