

SIMLETECH INC  
Form 10-Q  
May 11, 2005  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2005

or

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

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

Commission File Number 000-31623

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**SIMLETECH, INC.**

(Exact name of Registrant as specified in its charter)

**CALIFORNIA**  
(State or other jurisdiction)

**33-0399154**  
(I.R.S. Employer)

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of incorporation or organization)  
  
**3001 Daimler Street**  
**Santa Ana, CA**  
(Address of principal executive offices)

Identification No.)  
  
**92705-5812**  
(Zip Code)

**(949) 476-1180**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as described in Exchange Act Rule 12b-2). Yes  No

The number of shares outstanding of the registrant's common stock, par value \$0.001, as of March 31, 2005 was 45,114,021.

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**SIMLETECH, INC.**

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**QUARTERLY PERIOD ENDED MARCH 31, 2005**

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Except as otherwise noted in this report, SimpleTech, the Company, we, us and our collectively refer to SimpleTech, Inc.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****SIMLETECH, INC.****CONSOLIDATED BALANCE SHEETS****(in thousands, except share and per share amounts)****(unaudited)**

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
	<u>          </u>	<u>          </u>
<b>ASSETS:</b>		
Current Assets:		
Cash and cash equivalents	\$ 67,105	\$ 73,346
Marketable securities, held to maturity	2,086	9,972
Accounts receivable, net of allowances of \$1,242 at March 31, 2005 and \$993 at December 31, 2004	37,978	37,047
Inventory, net	33,552	19,002
Deferred income taxes	1,615	1,515
Other current assets	2,042	2,663
	<u>          </u>	<u>          </u>
Total current assets	144,378	143,545
Furniture, fixtures and equipment, net	5,754	6,146
Intangible assets	353	373
Deferred income taxes	2,733	3,345
	<u>          </u>	<u>          </u>
Total assets	\$ 153,218	\$ 153,409
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>		
Current Liabilities:		
Accounts payable	\$ 25,637	\$ 16,553
Accrued and other liabilities (Note 5)	4,420	5,428
	<u>          </u>	<u>          </u>
Total liabilities	30,057	21,981
Commitments and contingencies (Note 6)		
Shareholders' Equity:		
Preferred stock, \$0.001 par value, 20,000,000 shares authorized, no shares outstanding		
Common stock, \$0.001 par value, 100,000,000 shares authorized, 45,114,021 shares issued and outstanding as of March 31, 2005 and 47,450,722 shares issued and outstanding as of December 31, 2004	45	47
Additional paid-in capital	111,892	121,193
Retained earnings	11,224	10,188
	<u>          </u>	<u>          </u>
Total shareholders' equity	123,161	131,428

Total liabilities and shareholders' equity	<u>\$ 153,218</u>	<u>\$ 153,409</u>
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See accompanying notes to unaudited consolidated financial statements.

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## SIMpletech, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended March 31,	
	2005	2004
Net revenues	\$ 61,247	\$ 66,291
Cost of revenues	50,264	54,766
Gross profit	10,983	11,525
Sales and marketing	5,380	5,054
General and administrative	3,078	2,927
Research and development	1,287	844
Total operating expenses	9,745	8,825
Operating income	1,238	2,700
Interest income, net	435	200
Income from continuing operations before provision for income taxes	1,673	2,900
Provision for income taxes	637	1,227
Income from continuing operations	\$ 1,036	\$ 1,673
Loss from discontinued operations before benefit for income taxes		(2,447)
Benefit for income taxes		(1,073)
Loss from discontinued operations		\$ (1,374)
Net income (loss)	\$ 1,036	\$ 299
Net income (loss) per share:		
Basic:		
Continuing operations	\$ 0.02	\$ 0.04
Discontinued operations		\$ (0.03)
Total	\$ 0.02	\$ 0.01
Diluted:		
Continuing operations	\$ 0.02	\$ 0.03
Discontinued operations	\$	\$ (0.02)

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Total	<u>\$ 0.02</u>	<u>\$ 0.01</u>
Shares used in per share computation:		
Basic	<u>46,599</u>	<u>47,829</u>
Diluted	<u>48,044</u>	<u>50,214</u>

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****SIMpletech, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Cash flow from operating activities:</b>		
Net income (loss)	\$ 1,036	\$ 299
<b>Adjustments to reconcile net loss to net cash provided by operating activities:</b>		
Depreciation and amortization	696	892
Gain on sale of furniture, fixtures and equipment	(6)	(21)
Accounts receivable provisions	886	430
Inventory excess and obsolescence expense	44	315
Deferred income taxes	512	(49)
Tax Benefit of Employee Stock Option Exercise	30	64
<b>Change in operating assets and liabilities:</b>		
Accounts receivable	(1,818)	1,081
Inventory	(14,594)	(12,586)
Other current assets	622	686
Accounts payable	9,084	222
Accrued and other liabilities	(1,008)	(401)
<b>Net cash used in operating activities</b>	<b>(4,516)</b>	<b>(9,068)</b>
<b>Cash flows from investing activities:</b>		
Sales (purchases) of marketable securities, net	7,886	(1,608)
Purchase of furniture, fixtures and equipment	(311)	(599)
Proceeds from sale of furniture, fixtures and equipment	33	525
<b>Net cash provided by (used in) investing activities</b>	<b>7,608</b>	<b>(1,682)</b>
<b>Cash flows from financing activities:</b>		
Cost of equity issuance		(34)
Stock Buyback	(9,489)	
Proceeds from issuance of common stock	156	199
<b>Net cash (used in) provided by financing activities</b>	<b>(9,333)</b>	<b>165</b>
<b>Net decrease in cash</b>	<b>(6,241)</b>	<b>(10,585)</b>
Cash and cash equivalents at beginning of period	73,346	30,769
<b>Cash and cash equivalents at end of period</b>	<b>\$ 67,105</b>	<b>\$ 20,184</b>



See accompanying notes to unaudited consolidated financial statements.

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**SIMPLETECH, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 Basis of Presentation**

The accompanying interim consolidated financial statements of SimpleTech, Inc., a California corporation (the Company), are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all normal and recurring adjustments considered necessary for a fair statement of the consolidated financial position of the Company at March 31, 2005, the consolidated results of operations for the three months ended March 31, 2005 and 2004, and the consolidated results of cash flows for the three months ended March 31, 2005 and 2004, have been included. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the most recent Annual Report on Form 10-K filed with the SEC. The December 31, 2004 balances reported herein are derived from the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2004. The results for the interim periods are not necessarily indicative of results to be expected for the full year.

The consolidated financial statements of the Company include the accounts of the Company's subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Note 2 Summary of Significant Accounting Policies**

*Use of Estimates:*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., bad debt reserves and inventory reserves), disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Concentrations:*

As shown in the table below, customer concentrations of accounts receivable and revenues of greater than 10% were as follows:

**For the Three Months Ended March 31,**

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	2005		2004	
	Accounts Receivable	Revenues	Accounts Receivable	Revenues
Customer A	25%	19%	17%	12%
Customer B	12%	11%		
Customer C	11%	18%	14%	18%

For the three months ended March 31, 2005 and 2004, international sales comprised 13% and 21%, respectively, of the Company's revenues. During these periods, no single foreign country accounted for more than 10% of total revenues. Substantially all of the Company's international sales are export sales, which are shipped from the Company's domestic facility to foreign customers.

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### *Warranties:*

The Company's memory products are generally sold under various limited warranty arrangements, which range from one year to the product's lifetime. Estimated warranty costs are recorded concurrently with the recognition of revenue. The estimated future costs of repair or replacement are immaterial and have approximated management's estimates.

### *Sales and marketing incentives:*

Sales and marketing incentives were offset against revenues or charged to operations in accordance with Emerging Issues Task Force Issue No. 01-09. Sales and marketing incentives amounted to \$2.2 million and \$1.9 million for the three months ended March 31, 2005 and 2004, respectively, of which \$2.0 million and \$1.2 million, respectively, were offset against revenues, and \$160,000 and \$720,000, respectively, were charged as an operating expense.

### *Shipping and handling costs:*

Shipping and handling costs incurred in a sales transaction to ship products to a customer are included in sales and marketing. For the three months ended March 31, 2005 and 2004, shipping and handling costs were approximately \$477,000 and \$674,000, respectively.

### *Income taxes:*

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the year and the change during the year in deferred income tax assets and liabilities. The difference between the effective tax rate and the statutory rates for the three-month periods ended March 31, 2005 and 2004 reflects the recognition of tax credits related to research and development and enterprise zone hiring credits.

### *Reclassifications:*

Certain reclassifications have been made to prior period amounts to conform with the current period presentation.

## **Note 3 Net Income (Loss) Per Share**

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Basic earnings per share is computed by dividing net income (loss) by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect the potentially dilutive securities. Options to purchase 9,581,744 and 8,895,287 shares of common stock were outstanding at March 31, 2005 and 2004, respectively. For the three months ended March 31, 2005 and 2004, potentially dilutive securities consisted solely of options and resulted in potential common shares of 1,444,610 and 2,384,408, respectively.

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Pursuant to SFAS No. 123, Accounting for Stock-Based Compensation, the Company has elected to continue the intrinsic value method of accounting for stock options granted to employees and directors in accordance with APB Opinion No. 25 and related interpretations in accounting for stock option plans. Had compensation cost been determined based on the fair value at the grant dates for stock options under the Plan consistent with the method promulgated by SFAS No. 123, the Company's net income (loss) for the three months ended March 31, 2005 and 2004, would have resulted in the pro forma amounts below:

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(in thousands, except per share amounts)</b>	
Net income, as reported	\$ 1,036	\$ 299
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(928)	(1,011)
<b>Pro forma net income (loss)</b>	<b>108</b>	<b>(712)</b>
<b>Income (loss) per share:</b>		
Basic as reported	\$ 0.02	\$ 0.01
Basic pro forma	\$ 0.00	\$ (0.01)
Diluted as reported	\$ 0.02	\$ 0.01
Diluted pro forma	\$ 0.00	\$ (0.01)

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value. On April 14, 2005, the U.S. Securities and Exchange Commission adopted a new rule amending the compliance dates for SFAS No. 123(R). In accordance with the new rule, the accounting provisions of SFAS No. 123(R) will be effective for the Company in fiscal 2006. The Company is currently assessing the impact that adoption of this standard will have on its consolidated financial statements; however, the Company has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123, as amended.

**Note 4 Supplemental Balance Sheet Information**

Inventory consists of the following:

<u>(in thousands)</u>	<b>March 31, 2005</b>	<b>December 31, 2004</b>
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Raw materials	\$ 19,001	\$ 12,316
Work-in-progress	1,408	1,541
Finished goods	14,365	6,485
	<u>34,774</u>	<u>20,342</u>
Valuation allowances	(1,222)	(1,340)
Inventory, net	<u>\$ 33,552</u>	<u>\$ 19,002</u>

**Table of Contents****Note 5 Accrued and Other Liabilities**

Accrued and other liabilities consisted of the following as of:

<u>(in thousands)</u>	<u>March 31,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
Payroll costs	\$ 2,843	\$ 2,837
Marketing	729	1,079
Other	848	1,512
<b>Total</b>	<b>\$ 4,420</b>	<b>\$ 5,428</b>

**Note 6 Commitments and Contingencies****DPAC Technologies, Inc. Patent Infringement**

On September 23, 1998, the Company filed a lawsuit against DPAC Technologies, Inc., formerly Dense-Pac Microsystems, Inc. ( DPAC ), in the United States District Court for the Central District of California for infringement of the Company's IC Tower stacking patent, U.S. Patent No. 5,514,907. On March 29, 2001, the District Court entered final judgment finding DPAC did not infringe the Company's patent and that the Company did not infringe DPAC's patent. The Appeals Court affirmed the final judgment on March 7, 2002. On June 3, 2002, the Company filed a petition for certiorari with the U.S. Supreme Court. On October 7, 2002, the petition to the Supreme Court was granted and the matter was remanded to the Circuit Court of Appeals. DPAC filed a motion for summary affirmance with the Circuit Court of Appeals. The Court of Appeals denied the motion and remanded the matter back to District Court to reconsider the case in light of a recent decision by the U.S. Supreme Court. On September 15, 2003, the District Court re-entered judgment that DPAC does not infringe the Company's patent. Subsequently, the Company filed the appropriate documents to seek review of the last decision.

On March 8, 2004, the Company entered into a confidential settlement agreement whereby it agreed to dismiss with prejudice its appeal of the case. Under the settlement, the Company granted DPAC a paid-up, non-exclusive license under the affected patents. This settlement is a complete and amicable resolution and should not be construed as an admission by any of the parties to this litigation of any wrongdoing.

**Lemelson Medical, Education & Research Foundation, LLP Patent Infringement**

The Company received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP ( Lemelson Foundation ) filed a complaint on November 13, 2001 against the Company and other defendants. The complaint was filed in the District Court of Arizona and alleges that the Company's manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, the Company was served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against



other parties involving the same patents. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it.

**Staktek Corporation Patent Infringement**

On July 30, 2003, the Company filed a lawsuit against Staktek Corporation in the United States District Court for the Central District of California for infringement of its IC Tower stacking patent, U.S. Patent No. Re. 36,916. The Company sought monetary damages in an amount to be stated later, an injunction against further

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infringement of its patent, attorneys' fees and trebled damages. Staktek answered the complaint denying infringement and alleging that the patent is invalid.

On October 10, 2003, Staktek Group, L.P., a subsidiary of Staktek Corporation, filed a lawsuit against the Company in the United States District Court for the Western District of Texas which alleged that the Company's IC Tower stacking products infringe on Staktek's U.S. patents Nos. 6,025,642 and 6,049,123. Staktek sought a permanent injunction against further infringement of the '642 and '123 patents, monetary damages in an amount to be stated later, interest on damages, costs and attorneys' fees and trebled damages.

On March 31, 2004, the Company resolved its two lawsuits with Staktek Group L.P. The parties agreed to a mutual dismissal with prejudice of the intellectual property infringement lawsuits. In settlement of these matters, both parties agreed not to sue each other, its customers, or licensees in the future for patent infringement in connection with making or selling the products related to the lawsuits. Under the terms of the settlement, no money was exchanged, and neither party licensed its technology to the other.

## **Other Legal Proceedings**

The Company is currently not a party to any other material legal proceedings. However, the Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to other legal proceedings arising in the ordinary course of business.

## **Indemnification**

The Company has agreements whereby the Company indemnifies its officers and directors over his or her lifetime for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that limits the Company's exposure and should enable the Company to recover a portion of any future amounts paid. As a result of the Company's insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. All of these indemnification agreements were grandfathered under the provisions of FIN No. 45 as they were in effect prior to December 31, 2002. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2005.

As is common in the industry, the Company currently has in effect a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company's products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. The Company's insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2005.

## **Other Commitments**

The Company is subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, the Company may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of March 31, 2005, the Company has not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that the Company will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately \$524,000 and \$244,000 in the three months ended March 31, 2005 and 2004, respectively.

**Table of Contents****Note 7 Segment Information**

The Company reports financial results for two reportable operating segments: OEM and Consumer. The Company does not aggregate any operating segments.

The accounting policies for each of the reportable operating segments are the same as those described in Note 2 from the Company's Annual Report on Form 10-K for the year ended December 31, 2004 and reflect the information used by the Company's management to evaluate the performance of its segments. For the OEM and Consumer segments, the Company tracks separately net sales and gross profit, but does not track separately operating expenses. The Company does not maintain separate records to identify assets by operating segment.

Summarized financial information regarding the Company's two reportable segments is shown in the following table:

	<b>Three Months Ended March 31, 2005</b>		
	<b>Consumer</b>	<b>OEM</b>	<b>Consolidated</b>
Net Revenues	\$ 34,331	\$ 26,916	\$ 61,247
Cost of Revenues	29,895	20,369	50,264
Gross Profit	\$ 4,436	\$ 6,547	10,983
Operating Expenses			9,745
Operating Income			\$ 1,238

	<b>Three Months Ended March 31, 2004</b>		
	<b>Consumer</b>	<b>OEM</b>	<b>Consolidated</b>
Net Revenues	\$ 38,216	\$ 28,075	\$ 66,291
Cost of Revenues	31,962	22,804	54,766
Gross Profit	\$ 6,254	\$ 5,271	11,525
Operating Expenses			8,825
Operating Income *			\$ 2,700

\* From continuing operations

**Note 8 Stock Repurchase**

In June 2004, the Company's board of directors authorized the repurchase of up to \$15 million of its outstanding common stock from time to time over the next 18 months. The Company repurchased 2,414,964 shares of common stock at an average share price of \$3.90, including commissions, in the first quarter of 2005. The Company repurchased 841,509 shares of common stock at an average share price of \$3.68, including commissions, in the year 2004. Shares may be purchased from time to time at prevailing market prices through open market or unsolicited negotiated transactions, depending on market conditions and other considerations. There is no guarantee as to the exact number of shares that will be repurchased by the Company, and the Company may discontinue purchases at any time when its management determines that additional purchases are not warranted. Repurchased shares would be returned to the status of authorized but unissued shares of common stock. The Company believes that all funds required for the repurchase of common stock will be obtained from its available cash resources and marketable securities.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Cautionary Statement**

Certain statements in this report, including statements regarding our strategy, financial performance and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled "Risk Factors" set forth in this Form 10-Q and similar discussions in filings with the Securities and Exchange Commission made from time to time, including other quarterly reports on Form 10-Q, our Annual Reports on Form 10-K, and in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition.

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto.

**Overview**

SimpleTech, Inc. was originally incorporated in California in March 1990 as Simple Technology, Inc. Our name was then changed to SimpleTech, Inc. in May 2001. SimpleTech designs, manufactures and markets custom and open-standard memory and storage solutions based on Flash memory, Dynamic Random Access Memory (DRAM), and hard disk drive (HDD) technologies. Headquartered in Santa Ana, California, we offer a comprehensive line of more than 2,500 products and specialize in developing high-density memory modules, memory cards and storage solutions. One way in which SimpleTech distinguishes itself in the marketplace is by offering Flash, DRAM and HDD-based solutions used by consumer and original equipment manufacturers (OEMs). This allows the company to service a diverse customer base with multiple memory and storage formats thereby enabling customers to purchase all of their memory and storage requirements from one supplier.

In June 2004, we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC.

Over the past several years we have experienced an increase in demand for our Flash products as a result of the growth in consumer electronics and OEM applications, such as the replacement of rotating disk drives with Flash products. Our Flash revenues increased from \$24.9 million for the year ended December 31, 1999 to \$80.3 million for the year ended December 31, 2003, and then declined to \$62.2 million for the year ended December 31, 2004. Our revenues from Flash products in 2004 were negatively impacted by Flash supply constraints and competitive component pricing issues.

In the early part of 2005, we expect to face transitional challenges as we introduce, and some of our customers transition to, our latest generation of stacked and monolithic memory modules. We experienced a 46% sequential decrease in the sales of our stacked memory products in the first quarter of 2005 due primarily from delayed orders related to the process of qualifying some of our latest generation stacked modules with customers as they transition certain of their OEM solutions from PC 2100 to PC 2700 and from DDR I to DDR II technologies. The qualification process has taken longer than expected and although these transitional challenges may impact our second quarter of 2005 results, we believe that

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these issues can be resolved by the end of the second quarter of 2005. We expect sales of our stacked memory products to increase once these qualification issues have been resolved.

In 2004, we targeted the following five areas for future revenue growth which we continue to pursue in 2005:

Continue to develop Flash-based products for military applications;

Expanding presence in new markets such reduced-sized Flash cards for mobile handsets;

Targeting new customers for our Value-add OEM DRAM memory solutions;

Introducing external NAS storage devices in retail stores and for OEMs; and

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Expanding our international business in Asia and Europe.

We have begun to execute on some of these initiatives through the launch of our Zeus product line of Flash-based solid state drives for military storage applications in December 2004 and the test marketing of our SimpleShare product line of network attached external storage drives in certain retail channels during the first quarter of 2005.

We do not expect continued pursuit of these initiatives to have a material impact on our quarterly general and administrative and research and development expenses in 2005 compared to our recent quarterly run rates. However, if revenues increase due to the execution of these initiatives, we expect related increases in sales and marketing expenses.

We sell our products through our Consumer Division and OEM Division. Our Consumer Division sells our products through the following channels: VAR, mail order, distributor and mass market retailer. Our OEM Division was created in late 1998 to enhance the marketing of our products to OEMs.

Gross profit as a percentage of revenues for our OEM Division is typically higher than our Consumer Division. We track revenues and gross margins for our Consumer and OEM Divisions. We do not track separately, and do not intend to track separately, operating expenses for our Consumer and OEM Divisions.

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 68.1% of our total revenues in the first quarter of 2005 compared to 59.2% of our total revenues in the first quarter of 2004. Smart Modular, CDW Computer Centers, and Hewlett-Packard accounted for 19.1%, 17.8% and 10.5%, respectively, of our total revenues in the first quarter of 2005. CDW Computer Centers, Micron Semiconductor and Smart Modular accounted for 18.0%, 12.7% and 11.6%, respectively, of our total revenues in the first quarter of 2004. Other than Smart Modular, CDW Computer Centers, Micron Semiconductor and Hewlett-Packard, no other customer accounted for more than 10.0% of our total revenues in the first quarter of 2005 and first quarter of 2004. The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, would harm our business, financial condition and results of operations. See Risk Factors Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.

International sales of our products accounted for 12.5% of our revenues in the first quarter of 2005 compared to 21.1% of our revenues in the first quarter of 2004. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in the first quarter of 2005 or first quarter of 2004. For each of the first quarters of 2005 and 2004, more than 95.0% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

In the past, we have been, and expect to continue to be, impacted by seasonal purchasing patterns resulting in lower sales in the first and second quarters of each year. Other factors, including component price fluctuations, may distort the effect of seasonality. Our ability to adjust our short-term operating expenses in response to fluctuations in revenues is limited. As a result, should revenues decrease to a level lower than expected in any given period, our results of operations would be harmed.



**Discontinued Operations of Xiran Division**

In June 2004, we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC. The Xiran Division developed advanced board-level solutions that optimized server performance for networked storage applications, including IP storage. In the first half of 2004, the discontinued Xiran Division recorded a \$4.1 million operating loss before benefit for income taxes. In addition, we took a pre-tax charge of approximately \$3.0 million that included a \$1.5 million write-off of inventory, an \$802,000 write-off reflecting the net book value of Xiran Division fixed assets that will no longer be used, a \$310,000 write-off of the net book value of the intangible asset recorded at the date

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of acquisition, a \$173,000 lease impairment charge related to the Xiran Division office space that will no longer be used, \$102,000 in severance costs of Xiran Division employees who are no longer employed by us, and approximately \$51,000 in other charges. Monthly rent on the Xiran Division office lease, which expires on June 30, 2005, is approximately \$22,000. In calculating the lease impairment charge, we reduced the total lease liability by the estimated fair market value of sublease rental income. The closure of the Xiran Division had no impact on net revenues, gross profit or net income in the three months ended March 31, 2005.

**Results of Operations Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004**

*Net Revenues.* Our revenues were \$61.2 million in the first quarter of 2005, compared to \$66.3 million in the same period in 2004. Revenues decreased 7.7% in the first quarter of 2005 due to a 19% decrease in average sales price from \$75 in the first quarter of 2004 to \$61 in the first quarter of 2005, partially offset by a 14% increase in unit shipments. The decrease in our average sales price resulted from a shift in product mix away from our highest average capacity stacking products and a significant decline in DRAM component pricing in the first quarter of 2005 compared to the first quarter of 2004. The mix of products sold varies from quarter to quarter and may vary in the future, affecting our overall average sales prices and gross margins.

Our Consumer Division revenues decreased 10.2% from \$38.2 million in the first quarter of 2004 to \$34.3 million in the first quarter of 2005. Consumer Division revenues decreased in the first quarter of 2005 due to a 27% decrease in average sales price from \$59 in the first quarter of 2004 to \$43 in the first quarter of 2005, partially offset by a 21% increase in unit volume. The decrease in Consumer Division average sales price resulted primarily from a significant decrease in the average sales price of our Flash products in the first quarter of 2005 compared to the first quarter of 2004. Average sales price for Flash products decreased due to a significant decline in Flash component pricing in the first quarter of 2005 compared to the first quarter of 2004. Our OEM Division revenues decreased 4.1% from \$28.1 million in the first quarter of 2004 to \$26.9 million in the first quarter of 2005. The decrease in OEM Division revenues was due to a 6% decrease in OEM Division unit volume in the first quarter of 2005 compared to the first quarter of 2004 partially offset by a 2% increase in OEM Division average sales price from \$120 in the first quarter of 2004 to \$122 in the first quarter of 2005.

Sales of our products are made under short-term cancelable purchase orders. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming six months. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues. In addition, there can be no assurance that current backlog will necessarily lead to revenues in any future period. Our combined backlog was \$14.0 million as of March 31, 2005, compared to \$6.8 million as of March 31, 2004. Our Consumer Division backlog was \$3.4 million as of March 31, 2005, compared to \$1.3 million as of March 31, 2004. Our OEM Division backlog was \$10.6 million as of March 31, 2005, compared to \$5.5 million as of March 31, 2004. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

*Gross Profit.* Our gross profit was \$11.0 million in the first quarter of 2005, compared to \$11.5 million in the same period in 2004. Gross profit as a percentage of revenues was 18.0% in the first quarter of 2005, compared to 17.3% in the same period in 2004. Gross profit for our Consumer Division as a percentage of Consumer Division revenues was 12.9% in the first quarter of 2005, compared to 16.4% in the first quarter of 2004. Gross profit for our Consumer Division as a percentage of Consumer Division revenues for the first quarter of 2005 was negatively impacted by the significant decline in DRAM component pricing which resulted in a decrease in non-stacked DRAM gross profit. Gross profit for our OEM Division as a percentage of OEM Division revenues was 24.3% in the first quarter of 2005, compared to 18.8% in the first quarter of 2004. This increase in gross profit as a percentage of revenues for our OEM Division resulted primarily from a shift in product mix.

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*Sales and Marketing.* Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$5.4 million in the first quarter of 2005, compared to \$5.1 million in the same period in 2004. Sales and marketing expenses as a percentage of revenue were 8.8% in the first quarter of 2005, compared to 7.7% in the same period in 2004. The increase in sales and marketing expenses as a percentage of revenue was primarily due to negative operating expense leverage on a declining revenue base. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

*General and Administrative.* General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were relatively flat at \$3.1 million in our first quarter of 2005, compared to \$2.9 million in the first quarter of 2004. General and administrative expenses as a percentage of revenues were 5.1% in the first quarter of 2005 and 4.6% in the first quarter of 2004. The increase in general and administrative expenses as a percentage of revenue was primarily due to negative operating expense leverage on a declining revenue base. We expect our general and administrative expenses to decrease in absolute dollars in the future as we complete the primary phase of our Sarbanes-Oxley Act compliance efforts.

*Research and Development.* Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$1.3 million in the first quarter of 2005, compared to \$844,000 in the same period in 2004. Research and development expenses as a percentage of revenues were 2.1% in the first quarter of 2005, compared to 1.3% in the same period in 2004. Research and development expenses increased due to increased payroll costs and Flash and storage product design expenses in the first quarter of 2005 compared to the first quarter of 2004. We expect our research and development expenses to remain relatively flat in absolute dollars in the near future.

*Interest Income, Net.* Interest income, net was \$435,000 in the first quarter of 2005 and \$200,000 in the first quarter of 2004. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from an increase in average cash, cash equivalents and marketable securities balance and higher interest rates in the first quarter of 2005 compared to the first quarter of 2004.

*Provision for Income Taxes.* Provision for income taxes was \$637,000 in the first quarter of 2005. Provision for income taxes from continuing operations was \$1.2 million in the first quarter of 2004. As a percentage of income before provision for income taxes, provision for income taxes was 38% in the first quarter of 2005. As a percentage of income from continuing operations before provision for income taxes, provision for income taxes was 42% in the first quarter of 2004. The decrease in the effective tax rate from the first quarter of 2004 to the first quarter of 2005 was primarily due to investing a larger portion of marketable securities in federal tax exempt instruments during the first quarter of 2005.

*Net Income.* Net income was \$1.0 million in the first quarter of 2005. Net income from continuing operations was \$1.7 million in the first quarter of 2004.

*Discontinued Operations.* In June 2004, we discontinued the operation of our Xiran Division. No revenues or operating expenses were recorded in the first quarter of 2005 related to our discontinued Xiran Division. The operating expense figures above do not include operating expenses related to our discontinued Xiran Division during the first quarter of 2004.

## **Liquidity and Capital Resources**

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As of March 31, 2005, we had working capital of \$114.3 million, including \$67.1 million of cash and cash equivalents and \$2.0 million in marketable securities, compared to working capital of \$121.6 million, including \$73.3 million of cash and cash equivalents and \$10.0 million in marketable securities as of December 31, 2004. Current assets were 4.8 times current liabilities at March 31, 2005, compared to 6.5 times current liabilities at December 31, 2004.

Net cash used in operating activities was \$4.5 million for the first quarter of 2005 and resulted primarily from a \$14.6 million increase in inventory, net of reserves, and a \$932,000 increase in accounts receivable, net of allowances, offset by a \$9.1 million increase in accounts payable. Inventory, net of reserves, increased as a result of increased OEM Division orders, along with the anticipation of the nationwide launch of our external storage product line in the second quarter of 2005.

Net cash provided by investing activities was \$7.6 million for the first quarter of 2005, attributable to \$7.9 million of redemptions of marketable securities and \$311,000 in purchases of furniture, fixtures and equipment. We expect to spend approximately \$3.0 to \$5.0 million on capital expenditures during the next 24 months, primarily for the purchase of manufacturing, testing and engineering equipment.

Net cash used by financing activities was \$9.3 million for the first quarter of 2005 and resulted primarily from the \$9.5 million repurchase of our common stock under our stock buy back plan, partially offset by the issuance of common stock for proceeds of \$156,000 related to our employee stock purchase plan and stock option exercises.

In June 2004, our board of directors authorized the repurchase of up to \$15 million of our outstanding common stock from time to time over the next 18 months. We repurchased 841,509 shares of common stock

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at an average share price of \$3.68, including commissions, in 2004. We repurchased 2,414,964 shares of common stock at an average share price of \$3.90, including commissions, in the first quarter of 2005. Shares may be repurchased from time to time at prevailing market prices through open market or unsolicited negotiated transactions, depending on market conditions and other considerations. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue purchases at any time when management determines that additional purchases are not warranted. Repurchased shares would be returned to the status of authorized but unissued shares of common stock. We believe that all funds required for the repurchase of common stock will be obtained from our available cash resources and marketable securities.

We believe that our existing assets, cash, cash equivalents and investments on hand, together with cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. We cannot assure you that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

our relationships with suppliers and customers;

the market acceptance of our products;

the levels of promotion and advertising that will be required to launch our new products and achieve and maintain a competitive position in the marketplace;

expansion of our international business, including the opening of offices and facilities in foreign countries;

price discounts on our products to our customers;

our pursuit of strategic transactions;

our business, product, capital expenditure and research and development plans and product and technology roadmaps;

the levels of inventory and accounts receivable that we maintain;

our entrance into new markets;

capital improvements to new and existing facilities;

technological advances; and

competitors responses to our products.

**Contractual Obligations**

There have been no material changes to our Contractual Obligations described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004. We do not have off-balance sheet financing arrangements as of March 31, 2005.

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### **Inflation**

Inflation was not a material factor in either revenue or operating expenses during each of the first quarters of 2005 and 2004.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are: (a) the most important to the portrayal of our financial condition and results of operations, and (b) that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

*Reserves for inventory excess, obsolescence and lower of market values over costs.* We purchase raw materials in quantities that we anticipate will be fully used in the near term. Changes in operating strategy, customer demand and unpredictable fluctuations in market values of raw materials can limit our ability to effectively utilize all of the raw materials purchased and sold through resulting finished goods to customers for a profit. We regularly monitor potential excess, or obsolete, inventory by analyzing the length of time in stock and compare market values to cost. When necessary, we reduce the carrying amount of our inventory to its market value.

*Allowances for doubtful accounts and price protection.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We review our allowance for doubtful accounts quarterly and all past due balances over 90 days are reviewed for collectibility. Additionally, we maintain allowances for limited price protection rights for inventories of our products held by our customers as a result of recent sales transactions to them. If we reduce the list price of our products, these customers may receive a credit from us. By monitoring our inventory levels with our customers, we estimate the impact of such pricing changes on a regular basis and adjust our allowances accordingly.

*Product returns.* We offer a majority of our customers that purchase products through our consumer channels limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. We provide for estimated future returns of inventory at the time of sale based on historical experience, and actual results have been within our expectations.

*Sales and marketing incentives.* Sales and marketing incentives were offset against revenues or charged to operations in accordance with Emerging Issues Task Force Issue No. 01-09, EITF 01-09. Sales and marketing incentives amounted to \$2.2 million for the first quarter of 2005 and \$1.9 million for the first quarter of 2004, respectively, of which \$2.0 million and \$1.2 million, respectively, were offset against revenues, and \$160,000 and \$720,000, respectively, were charged as an operating expense.

Consideration generally given by us to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if we receive an identifiable benefit in return for the consideration given to our customer that is sufficiently separable from our sales to that customer, such that we could have paid an independent company to receive that benefit; and we can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense. We estimate the fair value of the benefits we receive by tracking the advertising done by our customers on our behalf and calculating the value of that advertising using a comparable rate for similar publications.

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*Income taxes.* As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. The process incorporates an assessment of the current tax exposure together with temporary differences resulting



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from different treatment of transactions for tax and financial statement purposes. Such differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. The recovery of deferred tax assets from future taxable income must be assessed and, to the extent that recovery is not likely, we establish a valuation allowance. Increases in valuation allowances result in the recording of additional tax expense. Further, if our ultimate tax liability differs from the periodic tax provision reflected in the consolidated statements of operations, additional tax expense may be recorded.

*Litigation and other contingencies.* Management regularly evaluates our exposure to threatened or pending litigation and other business contingencies. Because of the uncertainties related to the amount of loss from litigation and other business contingencies, the recording of losses relating to such exposures requires significant judgment about the potential range of outcomes. As additional information about current or future litigation or other contingencies becomes available, our management will assess whether such information warrants the recording of additional expense relating to our contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

*Valuation of long-lived assets.* We assess the potential impairment of long-lived tangible and intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Changes in our operating strategy can significantly reduce the estimated useful life of such assets.

## **Risk Factors**

*This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. You should carefully consider the following risks before you decide to buy shares of our common stock. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, including those risks set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations above, may also adversely impact and impair our business. If any of the following risks actually occur, our business, results of operations or financial condition would likely suffer. In such case, the trading price of our common stock could decline, and you may lose all or part of the money you paid to buy our stock. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.*

**We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.**

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Our future results of operations will depend on many factors including:

Our suppliers' production levels for the components used in our products;

Our ability to procure required components or fluctuations in the cost of such components;

Fluctuating market demand for, and changes in the average sales prices of our products;

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Changes in our product and revenue mix;

Seasonal purchasing patterns for our products with lower sales generally occurring in the first and second quarters followed by higher sales in the fourth quarter of each year;

Market acceptance of new and enhanced versions of our products;

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Expansion of our international business, including the opening of offices and facilities in foreign countries;

The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;

Order cancellations, product returns, inventory write-downs, price protections, and rebates;

Manufacturing inefficiencies associated with the start-up of new products and volume production;

Expenses associated with acquisitions;

Our ability to adequately support future rapid growth;

Our ability to absorb manufacturing overhead;

The effects of litigation;

Increases in our sales and marketing expenses in connection with decisions to pursue new product initiatives; and

Expenses associated with the start up of new operations or divisions.

Due to the above and other factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock would likely decline. In addition, the trading price of our common stock may fluctuate or decline regardless of our operating performance.

**Our dependence on a small number of suppliers for integrated circuit, or IC, devices and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.**

IC devices represent more than 90% of the component costs of our manufactured Flash cards and DRAM modules. We are dependent on a small number of suppliers that supply Flash and DRAM components. We have no long-term DRAM or Flash IC device supply contracts. Some of our competitors have entered into long-term contracts with suppliers that guarantee them a certain allocation of Flash IC devices. We have no assurance that our existing suppliers will agree to supply the quantities of Flash IC devices we may need to meet our production goals. We periodically review opportunities to develop alternative sources for our Flash and DRAM IC device needs. However, our options are very limited because of the small number of memory manufacturers. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. Renesas, Matsushita and Samsung supply substantially all of the IC devices used in our Flash memory products. In addition, Infineon Technologies, Micron Technology and Samsung currently supply a majority of the DRAM IC devices used in our DRAM and IC Tower stacking DRAM memory products. A disruption in or termination of our supply relationship with any of these significant suppliers due to natural disasters or other factors, or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers and negatively affect our

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revenues and could increase our costs or the prices of our products. In particular, if our supply relationships with Infineon Technologies, Micron Technology or Samsung are disrupted or terminated, our ability to manufacture and sell our DRAM and Flash products would be harmed and our business would be adversely affected.

Moreover, from time to time, our industry experiences shortages in Flash and DRAM IC devices which have required some vendors to place their customers, ourselves included, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. If we are unable to obtain sufficient Flash IC devices and other components to meet our customers' requirements, they may reduce future orders or eliminate us as a supplier and our revenues may decline. Additionally, our reputation could be harmed, we may not be able to replace any lost business with new customers, and we may lose market share to our competitors.

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### **Declines in our average sales prices may result in declines in our revenues and gross profit.**

Our average sales prices may decline due to several factors. During the majority of 2001 and 2002, and the first four months of 2003, overcapacity in the DRAM memory component market resulted in significant declines in component prices, which negatively impacted our average sales prices, revenues and gross profit. Declines in semiconductor prices could also affect the valuation of our inventory, which could harm our financial results. During periods of overcapacity, our revenues and gross profit will decline if we do not increase unit sales of existing products or fail to introduce and sell new products in quantities sufficient to offset declines in sales prices. Our efforts to reduce costs and develop new products to offset the impact of further declines in average sales prices may not be successful. Declines in average sales prices would also enable OEMs to pre-install higher capacity base memory into new systems at existing price points, and thereby reduce the demand for our aftermarket memory products.

In addition, the continued transition to smaller design geometries and the use of 300 millimeter wafers by existing memory manufacturers could lead to a significant increase in the worldwide supply of DRAM and Flash components. Increases in the worldwide supply of DRAM and Flash components could also result from manufacturing capacity expansions. If not offset by increases in demand, these increases would likely lead to further declines in the average sales prices of our products and have a material adverse effect on our business and operating results. Furthermore, even if supply remains constant, if demand were to decrease, it would harm our average sales prices.

### **We are subject to the cyclical nature of the semiconductor industry and any future downturn could adversely affect our business.**

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices. Any future downturns could have a material adverse effect on our business and results of operations.

### **Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.**

Our dependence on a limited number of customers means that the loss of a major customer or any reduction in orders by a major customer would materially reduce our revenues. Historically, a relatively limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 68.1% of our total revenues in the first quarter of 2005 compared to 59.2% of our total revenues in the first quarter of 2004. Our ten largest Consumer Division customers accounted for an aggregate of 69.3% of our Consumer Division revenues, or 38.8% of our total revenues, in the first quarter of 2005 compared to 62.3% of our Consumer Division revenues, or 35.9% of our total revenues, in the first quarter of 2004. Our largest Consumer Division customer in each of the first quarters of 2005 and 2004, CDW Computer Centers, accounted for 31.8% of our Consumer Division revenues, or 17.8% of our total revenues, for the first quarter of 2005 compared to 31.2% of our Consumer Division revenues, or 18.0% of our total revenues, in the first quarter of 2004. No other Consumer Division customer accounted for more than 10.0% of our total revenues in each of the first quarters of 2005 or 2004.

Our ten largest OEM Division customers accounted for an aggregate of 86.4% of our OEM Division revenues, or 38.0% of our total revenues, in the first quarter of 2005 compared to 82.3% of our OEM Division revenues, or 34.9% of our total revenues, in the first quarter of 2004. Our two largest OEM Division customers in the first quarter of 2005, Smart Modular and Hewlett-Packard, accounted for 43.3% and 18.9%, respectively,

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of our OEM Division revenues, or 19.1% and 10.5%, respectively, of our total revenues. Our two largest OEM customers in the first quarter of 2004, Micron Semiconductor and Smart Modular, accounted for 29.9% and 27.4%, respectively, of our OEM Division revenues, or 12.7% and 11.6%,

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respectively, of our total revenues. No other OEM Division customer accounted for more than 10.0% of our total revenues in each of the first quarters of 2005 or 2004.

Consolidation in some of our customers' industries may result in increased customer concentration and the potential loss of customers as a result of acquisitions. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers' products changes, and we expect this variability to continue in the future. We expect that sales of our products to a limited number of customers will continue to contribute materially to our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, could harm our business, financial condition and results of operations.

**Our ability to use our tax credit carryforwards may be substantially limited, which could harm our financial condition.**

We have generated tax credits in recent years, which we are not fully able to utilize at this time. The availability of some of these credit carryforwards is subject to expiration and/or certain limitations. As of March 31, 2005, we had federal research and development credit carryforwards of approximately \$1.3 million which begin to expire in 2022. In addition, we had the following state credits as of March 31, 2005: research and development credit carryforwards of approximately \$1.9 million, which carryforward indefinitely; enterprise zone credit carryforwards of approximately \$2.0 million, which carryforward indefinitely; and manufacturer's investment credit carryforwards of approximately \$372,000, which begin to expire in 2009. We are required to periodically review our ability to use our tax credit carryforwards. Such review may result in the limiting of the amount of tax credit carryforwards that can be utilized in the future to offset future tax liabilities. Since the limitation is based on a number of factors, we cannot determine the impact of such a limitation at this time, but if our ability to use tax credit carryforwards were substantially limited, it could harm our financial condition.

**New accounting and financial reporting requirements, including new standards that affect how we account for equity compensation, may impact our financial results.**

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting policies. A change in these policies could significantly impact our reported results and could retroactively affect previously reported transactions.

In addition, there has been an ongoing public debate as to whether employee stock option and employee stock purchase plan shares should be treated as a compensation expense and, if so, how to properly value such charges. We have accounted for employee stock options and employee stock purchase plan shares for financial and accounting purposes under APB Opinion No. 25, which does not count the grant of stock or options as an expense. In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R) which amended financial accounting standards and will require that awards under such plans be treated as compensation expense using the fair value method. On April 14, 2005, the U.S. Securities and Exchange Commission adopted a new rule amending the compliance dates for SFAS No. 123(R). In accordance with the new rule, the accounting provisions of SFAS No. 123(R) will be effective in fiscal 2006. Although management is continuing to assess the implications of this revised standard, we believe this revised standard will likely significantly increase our compensation expense, could make our operating results less predictable and could change the way we compensate our employees or cause other changes in the way we conduct our business.

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### **Failure to maintain effective internal control over financial reporting could result in a negative market reaction.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we undertake a thorough re-examination of our internal control systems and procedures for financial reporting. We also are required to completely document and test those systems. Ultimately, our management will be responsible for assessing the effectiveness of our internal control over financial reporting, and our independent registered public accounting firm will be requested to attest to that report. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations since there is no precedent available by which to measure compliance adequacy.

If we identify one or more material weaknesses in our internal control over financial reporting, our management will be unable to assert such internal controls are effective. If we are unable to assert that our internal control over financial reporting is effective, or if our independent registered public accounting firm is unable to attest that our management's report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls, it could result in a negative market reaction.

### **Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.**

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq National Market rules, have required most public companies, including us, to devote additional internal and external resources to various governance and compliance matters. Because we have a relatively small corporate staff, we rely heavily on outside professional advisers to assist us with these efforts. Although we are uncertain about the total costs we will incur in connection with these efforts, we know they will at least be substantial. These costs will include increased accounting related fees associated with preparing the attestation report on our internal controls over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002. The costs to comply with evolving laws, regulations and standards may offset all or a portion of the savings we realized through our efforts to reduce our expenses in 2004 and expect to realize from our continuing cost reduction efforts. These new or changed laws, regulations and standards are subject to varying interpretations, as well as modifications by the government and Nasdaq. The way in which they are applied and implemented may change over time, which could result in even higher costs to address and implement revisions to compliance (including disclosure) and governance practices. We intend to invest the necessary resources to comply with evolving laws, regulations and standards. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed and we will be required to incur additional expenses.

### **We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.**

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders' percentage ownership, incur substantial debt, reduce our cash reserves or assume contingent liabilities.



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Furthermore, acquisitions may require material infrequent charges and could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

**Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.**

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our small management team may be diverted from our core business if we undertake any future acquisitions. Our recent and any potential future acquisitions also involve numerous risks, including, among others:

Problems assimilating the purchased operations, technologies or products;

Costs associated with the acquisition;

Adverse effects on existing business relationships with suppliers and customers;

Risks associated with entering markets and foreign countries in which we have no or limited prior experience;

Potential loss of key employees of purchased organizations; and

Potential litigation arising from the acquired company's operations before the acquisition.

Our inability to overcome problems encountered in connection with any acquisitions could divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of a potential future acquisition increases. For example, in June 2004 we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC. The Xiran Division developed advanced board-level solutions that optimize server performance for networked storage applications, including IP storage. We were unable to successfully bring the Xiran Division products to market after funding its operations for over two years. In connection with the discontinued operation, we recorded a one-time charge of approximately \$3.0 million in the second quarter of 2004.

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

**Three of our beneficial shareholders have substantial influence over our operations and could control all matters requiring shareholder approval.**

Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer and director of SimpleTech, are brothers and beneficially own approximately 61.5% of our outstanding common stock at March 31, 2005 (assuming the inclusion of shares of common stock subject to options that are presently exercisable or will become exercisable within 60 days of such date). In addition, they have a non-binding understanding that at any shareholders' meeting of SimpleTech where action is to be taken with respect to the election of directors, they each would cause the shares of SimpleTech common stock beneficially owned by them to be voted in favor of their election as directors. As a result, they have the ability to control all matters requiring approval by our shareholders, including the election and removal of directors, approval of significant corporate transactions and the decision of whether a change in control will occur. This control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

**We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.**

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The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third-party could claim that our products, which incorporate the products purchased or technology licensed from our suppliers and licensors, infringes a patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers' and licensors' obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

We are currently a party to one lawsuit regarding intellectual property as further described under Legal Proceedings. Because litigation is inherently uncertain, we cannot predict the outcome of this lawsuit. This lawsuit has diverted, and is expected to continue to divert, the efforts and attention of our key management and technical personnel. In addition, we have incurred, and expect to continue to incur, substantial legal fees and expenses in connection with this lawsuit. As a result, our defense of this lawsuit, regardless of its eventual outcome, has been, and will continue to be, costly and time consuming.

### **Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.**

We currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages.

### **Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.**

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess



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of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

### **Our intellectual property may not be adequately protected, which could harm our competitive position.**

Our intellectual property is critical to our success. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

Prevent the challenge, invalidation or circumvention of our existing patents;

Result in patents that lead to commercially viable products or provide competitive advantages for our products;

Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

Prevent third-party patents from having an adverse effect on our ability to do business;

Provide adequate protection for our intellectual property rights;

Prevent disputes with third parties regarding ownership of our intellectual property rights;

Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

As part of our confidentiality procedures, we enter into non-disclosure and invention assignment agreements with all of our employees and attempt to control access to and distribution of our technology, documentation and other proprietary information. However, if such agreements are found to be unenforceable, we may be unable to adequately protect our intellectual property rights. In addition, despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies.

In addition, if our IC Tower stacking patent is found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products to our IC Tower stacking products would cease. We have on at least one occasion applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

**We may not be able to maintain or improve our competitive position because of the intense competition in the memory industry.**

We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our primary competitors in the third-party memory module industry include: Crucial Memory, a division of Micron Technology, Kingston Technology, Lexar Media, M-Systems, PNY Technologies, SanDisk, and SMART Modular. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be able to respond better to new or emerging technologies or standards and to changes in customer requirements. Further, some of our competitors are in a better financial and marketing position from which to influence industry acceptance of a particular industry standard or competing technology than we are. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

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We expect to face competition from existing competitors and new and emerging companies that may enter our existing or future markets with similar or alternative products, which may be less costly or provide additional features. In addition, some of our significant suppliers, including Micron Semiconductor Electronics and Samsung Semiconductor, are also our competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance and improved pricing, any of which could cause a decline in sales or loss of market acceptance of our products. In addition, our competitors may develop enhancements to, or future generations of, competitive products that may render our technology or products obsolete or uncompetitive.

### **We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.**

The memory, high-performance computing, networking and communications, consumer electronics and OEM markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

We have experienced, and may in the future experience, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance. Accordingly, there can be no assurance that our new products, including our Zeus product line of Flash-based solid state drives and SimpleShare product line of network attached external drives, as well as any future product development efforts will result in future profitability or market acceptance. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations.

We may also seek to develop products with new standards for our industry. It will take time for these new standards and products to be adopted, for consumers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by consumers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. We cannot assure you that any new products or standards we develop will be commercially successful.

### **The Flash-based storage market is constantly evolving, and we may not have rights to manufacture and sell certain types of products utilizing emerging new Flash formats, or we may be required to pay a royalty to sell products utilizing these formats.**

The Flash-based storage market is constantly undergoing rapid technological change and evolving industry standards. Many consumer devices, such as digital cameras, PDAs and smartphones, may transition to emerging Flash memory formats, such as the xD Picture Card format, which

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we do not currently manufacture and do not have rights to manufacture. This will likely result in a decline in demand, on a relative basis, for other products that we manufacture such as CompactFlash, Secure Digital and MultiMedia cards. If we decide



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to manufacture Flash products utilizing emerging formats, such as the xD Picture Card, we will be required to secure licensing arrangements to give us the right to manufacture such products which may not be available at reasonable rates or at all. If we are not able to supply all Flash card formats at competitive prices or if we were to have product shortages, our revenues could be adversely impacted and our customers would likely cancel orders or seek other suppliers to replace us.

**The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.**

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer, Mike Moshayedi, our President, and Mark Moshayedi, our Chief Operating Officer, Chief Technical Officer and Secretary. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

**Ineffective management of inventory levels or product mix, order cancellations, product returns, inventory write-downs, price protection and rebates could adversely affect our results of operations.**

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products with our customers, we may incur increased and unexpected costs associated with this inventory. For example, if our Consumer Division customers are unable to sell their inventory in a timely manner, we may choose or be required to lower the price of our products or allow our customers to exchange the slow-moving products for newer products. Similarly, if we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. As a result, we could incur increased expenses associated with writing off excess or obsolete inventory. A majority of our sales through commercial channels include limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. In addition, some of our inventory is sold on a consignment basis, and we have very little ability to control or manage that inventory. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error.

We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were \$44,000 in the first quarter of 2005, compared to \$315,000 in the first quarter of 2004. In addition, we offer some of our Consumer Division customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of \$581,000 in the first quarter of 2005, compared to \$155,000 in the first quarter of 2004. We also offer rebate programs through some of our Consumer Division customers to end-users. We incurred rebate charges of \$125,000 in the first quarter of 2005, compared to \$0 in the first quarter of 2004.

We are also subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, we may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of March 31, 2005, we have never been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that we will be required to repurchase inventory, upon customer default, in the

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future. Sales under such agreements were \$524,000 in the first quarter of 2005, compared to \$244,000 in the first quarter of 2004.

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We have no long-term volume commitments from our customers. Sales of our products are made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. We have experienced cancellations of orders and fluctuations in order levels from period-to-period and we expect to continue to experience similar cancellations and fluctuations in the future, which could result in fluctuations in our revenues.

**Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.**

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select international markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations to third party contract manufacturers, establishing joint ventures with foreign partners, and the establishment of manufacturing operations in foreign countries. Establishing operations in any other foreign country or region presents numerous risks, including:

foreign laws and regulations, which may vary country by country, may impact how we conduct our business;

higher costs of doing business in certain foreign countries, including different employment laws;

difficulty protecting our intellectual property rights from misappropriation or infringement;

difficulties and costs of staffing and managing operations in certain foreign countries;

political or economic instability;

changes in import/export duties;

necessity of obtaining government approvals;

trade restrictions;

work stoppages or other changes in labor conditions;

difficulties in collecting of accounts receivables on a timely basis or at all;

taxes;

longer payment cycles and foreign currency fluctuations; and

seasonal reductions in business activity in some parts of the world, such as Europe.

In addition, changes in policies and/or laws of the United States or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. We may also encounter potential adverse tax consequences if taxing authorities in different jurisdictions worldwide disagree with our interpretation of various tax laws or our determinations as to the income and expenses attributable to specific jurisdictions, which could result in our paying additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international

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expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

**We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.**

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales of our products accounted for 12.5% and 21.1% of our revenues in each of the first quarters of 2005 and 2004, respectively. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the first quarters of 2005 or 2004. For each of the first quarters of 2005 and 2004, more than 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country's currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

We purchase a majority of the DRAM and Flash components used in our products from local distributors of foreign suppliers. Although our purchases of DRAM and Flash components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of DRAM and Flash components.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

**We have experienced quarterly and annual losses in the past and may continue to experience losses in the future.**

Although we have been profitable for most of our history, we have experienced losses on a quarterly and annual basis in the past. In 2003 and 2002, we incurred net losses of \$1.6 million and \$1.4 million, respectively. We have expended, and will continue to expend, substantial funds to pursue engineering, research and development projects, enhance sales and marketing efforts and otherwise operate our business. There can be no assurance that we will be profitable on a quarterly or annual basis in the future.

**Disruption of our operations in our Santa Ana, California, manufacturing facility would substantially harm our business.**

All of our manufacturing operations are located in our facility in Santa Ana, California. Due to this geographic concentration, a disruption of our manufacturing operations, resulting from sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, could cause us to cease or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

**Compliance with environmental laws and regulations could harm our operating results.**

We are subject to a variety of environmental laws and regulations governing, among other things, air emissions, waste water discharge, waste storage, treatment and disposal, and remediation of releases of hazardous materials. Our failure to comply with present and future requirements could harm our ability to continue manufacturing our products. Such requirements could require us to acquire costly equipment or to

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incur other significant expenses to comply with environmental regulations. The imposition of additional or more stringent environmental requirements, the results of future testing at our facilities, or a determination that we are potentially responsible for remediation at other sites where problems are not presently known to us, could result in expenses in excess of amounts currently estimated to be required for such matters.

### **Failure to comply with governmental laws and regulations could harm our business.**

Our business is subject to regulation by various federal and state governmental agencies. Such regulation includes the radio frequency emission regulatory activities of the Federal Communications Commission, the anti-trust regulatory activities of the Federal Trade Commission and Department of Justice, the consumer protection laws of the Federal Trade Commission, the import/export regulatory activities of the Department of Commerce, the product safety regulatory activities of the Consumer Products Safety Commission, the regulatory activities of the Occupational Safety and Health Administration, the environmental regulatory activities of the Environmental Protection Agency, the labor regulatory activities of the Equal Employment Opportunity Commission and tax and other regulations by a variety of regulatory authorities in each of the areas in which we conduct business. We are also subject to regulation in other countries where we conduct business. In certain jurisdictions, such regulatory requirements may be more stringent than in the United States. We are also subject to a variety of federal and state employment and labor laws and regulations, including the Americans with Disabilities Act, the Federal Fair Labor Standards Act, the WARN Act and other regulations related to working conditions, wage-hour pay, over-time pay, employee benefits, anti-discrimination, and termination of employment.

Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. In addition from time to time we have received, and expect to continue to receive, correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances the former employee has brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys' fees and costs.

These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees.

### **Our stock price is likely to be volatile and could drop unexpectedly.**

Our common stock has been publicly traded only since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management's attention and resources.

**Anti-takeover provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.**

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our amended and restated articles of incorporation and amended and restated bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.



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These provisions include:

limitations on who may call special meetings of shareholders;

advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

elimination of cumulative voting in the election of directors;

the right of a majority of directors in office to fill vacancies on the board of directors;

the ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

Provisions of our 2000 Stock Incentive Plan allow for the automatic vesting of all outstanding options granted under the 2000 Stock Incentive Plan upon a change in control under certain circumstances. Such provisions may have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Interest Rate Risk**

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital. We have not used derivative financial instruments in our investment portfolio.

At March 31, 2005, our cash and cash equivalents were \$67.1 million invested in money market and other interest bearing accounts.

At March 31, 2005, our investment in marketable securities was \$2.1 million. The marketable securities consist of certificates of deposit with an original maturity of one year at different financial institutions and auction rate securities. At March 31, 2005, these marketable securities had a weighted-average time to maturity of approximately 26 days. Marketable securities represent investments with an original maturity of greater than three months. These securities are classified as held to maturity because we have the intention and ability to hold the securities to maturity. Gross unrealized gains and losses on held-to-maturity marketable securities have historically not been material.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents of approximately \$671,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no

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such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

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The carrying amount, principal maturity and estimated fair value of our cash, cash equivalents and marketable securities as of March 31, 2005 were as follows:

	Expected Maturity Date			Fair Value 3/31/2005
	Before April 1, 2006	Thereafter	Total	
<b>Investments</b>				
Cash and cash equivalents:				
Money Market Funds	\$ 67,105,000	\$ 0	\$ 67,105,000	\$ 67,105,000
Weighted average interest rate	2.16%		2.16%	2.16%
Total cash and cash equivalents	\$ 67,105,000	\$ 0	\$ 67,105,000	\$ 67,105,000
Weighted average interest rate	2.16%		2.16%	2.16%
Marketable securities	\$ 2,086,000	\$ 0	\$ 2,086,000	\$ 2,086,000
Weighted average interest rate	1.57%		1.57%	1.57%

**Foreign Currency Exchange Rate Risk**

More than 95.0% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase substantially all of our DRAM and Flash components from local distributors of Japanese, Korean and Taiwanese suppliers. Fluctuations in the currencies of Japan, Korea or Taiwan could have an adverse impact on the cost of our raw materials. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

**ITEM 4. CONTROLS AND PROCEDURES**

(a) *Evaluation of Disclosure Controls and Procedures.* An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d-15 promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Securities Exchange Act within the time periods specified by the Securities and Exchange Commission's rules and forms.

(b) *Changes in Internal Controls.* During the quarterly period covered by this report, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**Lemelson Medical, Education & Research Foundation, LLP Patent Infringement**

We received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP filed a complaint on November 13, 2001 against us and other defendants. The complaint was filed in the District Court of Arizona and alleges that our manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, we were served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative. We believe this lawsuit is without merit and we intend to vigorously defend ourself against it.

We are not currently involved in any other material legal proceedings. We are not aware of any other material legal proceedings threatened or pending against us. From time to time, however, we may become subject to additional legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes. In addition, in the past we have received, and we may continue to receive in the future, letters alleging infringement of patent or other intellectual property rights. Our management believes that these letters generally are without merit and intend to contest them vigorously.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(b) Use of Proceeds from Sales of Registered Securities

On October 4, 2000, we completed our initial public offering of our common stock pursuant to our Registration Statement on Form S-1 (File No. 333-32478) that was declared effected by the Securities and Exchange Commission on September 28, 2000. There has been no material change with respect to our use of the net proceeds from our initial public offering to the information discussed in our Annual Report on Form 10-K for the year ended December 31, 2000. We continue to invest the remaining net proceeds in short-term, interest-bearing instruments, pending their use to fund working capital and other general corporate purposes, including expansion of sales and marketing activities, enhancement of our technology, possible acquisitions and international expansion.

(c) Issuer Purchases of Equity Securities

The number of shares of our common stock repurchased and the average price paid per share for each month in the three months ended March 31, 2005 are as follows:

Period	Total Number of	Average Price Paid	Total Number of	Maximum Dollar Value that May
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	Shares Purchased	per Share	Shares as Part of Publicly Announced Program (1)	Yet be Purchased Under the Program
January 1, 2005 through January 31, 2005	0	\$ 0	841,509	\$ 11,901,431
February 1, 2005 through February 28, 2005	1,556,369	\$ 3.86	2,397,878	\$ 5,846,075
March 1, 2005 through March 31, 2005	858,595	\$ 3.97	3,256,473	\$ 2,413,905
<b>Total (2)</b>	<b>2,414,964</b>	<b>\$ 3.90</b>	<b>3,256,473</b>	<b>\$ 2,413,905</b>

- (1) On June 16, 2004 we announced that our board of directors had authorized a share repurchase program enabling us to repurchase up to \$15 million of our common stock over an 18-month period expiring on December 16, 2006. The shares may be purchased from time to time at prevailing market prices through open market or unsolicited negotiated transactions, depending on market conditions and other considerations. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue purchases at any time that management determines that additional purchases are not warranted. Repurchased shares would be returned to the status of authorized but un-issued shares of common stock. In February 2005, our board of directors approved a plan

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under Rule 10b5-1 under the Securities Exchange Act of 1934 to facilitate the repurchase of our shares of common stock under our existing share repurchase program. Rule 10b5-1 allows us to purchase our shares at times when we ordinarily would not be in the market because of self-imposed trading blackout periods, such as the time immediately preceding our quarterly earnings releases. The 10b5-1 share purchase period commenced on March 1, 2005 and will continue until two trading days following our announcement of our results of operations for the first quarter of 2005.

- (2) All shares were purchased pursuant to our existing share repurchase program. As of April 30, 2005, we had repurchased 3,777,022 shares of our common stock at an average price of \$3.84 per share for an aggregate purchase price of \$14,498,845 since inception of our existing share repurchase program, and the remaining authorized amount for stock repurchases under this program was \$501,155.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
10.1	2000 Stock Incentive Plan Form of Notice of Grant of Stock Option
10.2	2000 Stock Incentive Plan Form of Stock Option Agreement
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless SimpleTech, Inc. specifically incorporates the foregoing information into those documents by reference.



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 11, 2005

SIMPLETECH, INC.,  
a California corporation

/s/ DAN MOSES  
Dan Moses  
Chief Financial Officer (Principal Financial

Officer and Duly Authorized Signatory)



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**SIMLETECH, INC.**

**Index to Exhibits**

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