

SIMLETECH INC  
Form 10-Q  
April 29, 2004  
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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, 2004

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)

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**CALIFORNIA**  
(State or other jurisdiction)

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

of incorporation or organization)

Identification No.)

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

**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, 2004 was 47,871,654.

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**QUARTERLY PERIOD ENDED MARCH 31, 2004**

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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, 2004</b>	<b>December 31, 2003</b>
	<u>          </u>	<u>          </u>
<b>ASSETS:</b>		
Current Assets:		
Cash and cash equivalents	\$ 20,184	\$ 30,769
Marketable securities	47,233	45,625
Accounts receivable, net of allowances of \$1,265 at March 31, 2004 and \$1,100 at December 31, 2003	31,525	33,036
Inventory, net	38,975	26,704
Deferred income taxes	1,315	1,087
Other current assets	1,550	2,236
	<u>          </u>	<u>          </u>
Total current assets	140,782	139,457
Furniture, fixtures and equipment, net	8,497	9,263
Intangible assets	341	372
Deferred income taxes	4,398	4,577
	<u>          </u>	<u>          </u>
Total assets	<u>\$ 154,018</u>	<u>\$ 153,669</u>
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>		
Current Liabilities:		
Accounts payable	\$ 20,839	\$ 20,388
Accrued and other liabilities	4,327	4,957
	<u>          </u>	<u>          </u>
Total liabilities	25,166	25,345
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, 47,871,654 shares issued and outstanding as of March 31, 2004 and 47,776,257 shares issued and outstanding as of December 31, 2003	48	48
Additional paid-in capital	123,006	122,777
Retained earnings	5,798	5,499
	<u>          </u>	<u>          </u>

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Total shareholders' equity	128,852	128,324
Total liabilities and shareholders' equity	\$ 154,018	\$ 153,669

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,	
	2004	2003 (Revised- Note 2)
Net revenues	\$ 66,291	\$ 40,918
Cost of revenues	54,766	33,846
Gross profit	11,525	7,072
Sales and marketing	5,634	5,372
General and administrative	3,095	2,538
Research and development	2,542	2,063
Total operating expenses	11,271	9,973
Income (loss) from operations	254	(2,901)
Interest income, net	199	151
Income (loss) before (provision) benefit for income taxes	453	(2,750)
(Provision) benefit for income taxes	(154)	1,190
Net income (loss)	\$ 299	\$ (1,560)
Net income (loss) per share:		
Basic	\$ 0.01	\$ (0.04)
Diluted	\$ 0.01	\$ (0.04)
Shares used in computation of net income (loss) per share:		
Basic	47,829	38,843
Diluted	50,214	38,843

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>2004</b>	<b>2003</b>
		<b>(Revised- Note 2)</b>
Cash flow from operating activities:		
Net income (loss)	\$ 299	\$ (1,560)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	892	944
Gain on sale of furniture, fixtures and equipment	(21)	(165)
Accounts receivable provisions	430	583
Inventory excess and obsolescence expense	315	25
Deferred income taxes	(49)	
Tax Benefit of Employee Stock Option Exercise	64	
Change in operating assets and liabilities:		
Accounts receivable	1,081	3,735
Inventory	(12,586)	3,340
Other current assets	686	(1,259)
Accounts payable	222	(7,250)
Accrued and other liabilities	(401)	(160)
<b>Net cash used in operating activities</b>	<b>(9,068)</b>	<b>(1,767)</b>
Cash flows from investing activities:		
Investments in marketable securities	(1,608)	(175)
Purchase of furniture, fixtures and equipment	(599)	(555)
Proceeds from sale of furniture, fixtures and equipment	525	64
<b>Net cash used in investing activities</b>	<b>(1,682)</b>	<b>(666)</b>
Cash flows from financing activities:		
Payment on capital lease obligations		(113)
Cost of equity issuance	(34)	
Proceeds from issuance of common stock	199	236
<b>Net cash provided by financing activities</b>	<b>165</b>	<b>123</b>
<b>Net decrease in cash</b>	<b>(10,585)</b>	<b>(2,310)</b>
Cash and cash equivalents at beginning of period	30,769	24,442
<b>Cash and cash equivalents at end of period</b>	<b>\$ 20,184</b>	<b>\$ 22,132</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 presentation of the consolidated financial position of the Company at March 31, 2004, the consolidated results of operations for the three months ended March 31, 2004 and 2003, and the consolidated results of cash flows for the three months ended March 31, 2004 and 2003, 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, 2003 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, 2003. 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 Revision of Financial Statements**

In its Annual Report on Form 10-K for the year ended December 31, 2003 filed with the SEC on March 31, 2004, the Company revised its previously issued consolidated financial statements for the quarter ended March 31, 2003 for the following three items:

In December 2003, the Company discovered a non-cash clerical error in computing depreciation related to two fixed asset categories during the three-year period ended December 31, 2003. As a result of correcting this error, operating expenses have been decreased by \$61,000 in the first quarter of 2003.

In the quarter ended June 30, 2003, the Company determined that the acquisition of Irvine Networks, LLC (now known as the Company's Xiran Division) previously recorded as a business combination in the quarter ended March 31, 2002, should instead have been recorded as an acquisition of assets. As such, in its previously issued financial statements for the quarter ended June 30, 2003, the Company recorded the effect of correcting this accounting entirely in that quarter, rather than by revising its previously issued financial statements. As a consequence, in the quarter ended June 30, 2003, the Company previously (i) reclassified \$540,000 of the \$835,000 goodwill that had been recorded at the time of the transaction to amortizable intangible assets, representing assembled workforce with an estimated life of five years, (ii) charged-off against income the remaining \$295,000 of goodwill, and (iii) recorded amortization expense of \$162,000 reflecting the \$135,000 cumulative effect of related amortization since the date of the acquisition as well as \$27,000 in amortization for the quarter ended June 30, 2003. After further analysis, the Company has now determined that the appropriate accounting would have been to retroactively reflect the effect of the asset acquisition for all periods since the date of acquisition. Consequently, the Company has revised its previously issued financial statements primarily to (i) increase by \$200,000, to \$1,560,000 the amount initially allocated to in-process research and development, (ii) increase by \$15,000, to \$115,000 the amount initially allocated to fixed assets, and (iii) allocate \$620,000 to assembled workforce, all as of the acquisition date in the quarter ended

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March 31, 2002. In addition, the goodwill write-off of \$295,000 and the cumulative amortization of \$135,000 relating to this transaction recorded in the quarter ended June 30, 2003, as well as the \$27,000 recorded for that quarter were reversed and instead the appropriate amortization charge of \$31,000

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has been recorded in each quarter since the date of acquisition. As a result of correcting this error, operating expenses have been increased by \$31,000 in the quarter ended March 31, 2003.

The Company has recorded in the quarter ended December 31, 2001 a write-down of \$141,000 of certain fixed assets, which were previously designated as held for sale in that quarter. Previously this write-down was recorded in the quarter ended March 31, 2003. As a result of correcting this error, cost of goods sold has been decreased by \$141,000 in the quarter ended March 31, 2003.

The combined effect of these revisions decreased the Company's net loss by \$101,000 in the quarter ended March 31, 2003. Additionally, these revisions had no impact on fully diluted earnings per share in the quarter ended March 31, 2003.

The effect of the revisions described above on the quarter ended March 31, 2003 is as follows (in thousands, except per share data):

**Statement of Operations:**

<u>Year Ended:</u>	<u>March 31, 2003</u>	
	<u>As Reported</u>	<u>As Revised</u>
Gross Profit	\$ 6,931	\$ 7,072
Loss from operations	(3,072)	(2,901)
Net loss	(1,661)	(1,560)
Net (loss) income per share:		
Basic	\$ (0.04)	\$ (0.04)
Diluted	\$ (0.04)	\$ (0.04)

**Note 3 Summary of Significant Accounting Policies**

*Management 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 of March 31, 2004, approximately 17% and 14% of accounts receivable were concentrated with two customers. As of December 31, 2003, approximately 11% of accounts receivable were concentrated with one customer. For the three months ended March 31, 2004, sales to three

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customers comprised 42% of the Company's revenues. For the three months ended March 31, 2003, sales to one customer comprised 22% of the Company's revenues. No other single customer accounted for more than 10% of accounts receivable at March 31, 2004 and December 31, 2003, or revenues for the three months ended March 31, 2004 and 2003.

For the three months ended March 31, 2004 and 2003, international sales comprised 21% and 22%, respectively, of the Company's revenues. During these periods, no single foreign country accounted for more than 10% of total revenues. For the three months ended March 31, 2003, Europe accounted for 13% of the Company's total revenues. Other than Europe in the three months ended March 31, 2003, no other

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foreign geographical area accounted for more than 10% of the Company's total revenues in three months ended March 31, 2004 and 2003. Substantially all of the Company's international sales are export sales, which are shipped from the Company's domestic facility to foreign customers.

### *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 \$1.9 million and \$2.2 million for the three months ended March 31, 2004 and 2003, respectively, of which \$1.2 million and \$1.0 million, respectively, were offset against revenues, and \$720,000 and \$1.2 million, 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, 2004 and 2003, shipping and handling costs were approximately \$674,000 and \$536,000, 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, 2004 and 2003 reflects the recognition of tax credits related to research and development and enterprise zone hiring credits.

There may be limitations on the Company's ability to utilize net operating loss carryforwards with future changes in ownership.

### *Reclassifications:*

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

*New Accounting Pronouncements:*

In November 2002, the EITF reached a consensus on Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. This Issue provides guidance on when and how to separate elements of an arrangement that may involve the delivery or performance of multiple products, services and rights to use assets into separate units of accounting. The guidance in the consensus is effective for revenue arrangements entered into in fiscal periods, interim or annual, beginning after June 15, 2003. The Company adopted Issue No. 00-21 on July 1, 2003. The adoption of Issue No. 00-21 did not have a material impact to the Company's consolidated financial position, results of operations, or cash flows.

In May 2003, the FASB issued SFAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some

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circumstances). Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003 (except for mandatory redeemable non-controlling interests). For all instruments that existed prior to May 31, 2003, SFAS 150 is effective at the beginning of the first interim period beginning after June 15, 2003 (except for mandatory redeemable non-controlling interests). For mandatory redeemable non-controlling interests, the FASB has deferred certain provisions of SFAS 150. The adoption of SFAS 150 did not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

In December 2003 the SEC issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 codifies, revises and rescinds certain sections of SAB No. 101 in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. Accordingly, there is no impact to the Company's results of operations, financial position or cash flows as a result of the issuance of SAB No. 104.

In December 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). FIN 46R requires the application of either FIN 46 or FIN 46R by Public Entities to all Special Purpose Entities (SPE) created prior to February 1, 2003 as of December 31, 2003 for calendar year-end companies. FIN 46R is applicable to all non-SPEs created prior to February 1, 2003 at the end of the first interim or annual period ending after March 15, 2004. For all entities created subsequent to January 31, 2003, Public Entities were required to apply the provisions of FIN 46. The adoption of FIN 46 did not have a material impact to the Company's consolidated financial position, results of operations or cash flows. The adoption of FIN 46R for SPEs did not have an impact to the Company's consolidated financial position, results of operations or cash flows, and the Company does not believe the adoption of FIN 46R for non-SPEs will have a material impact to its consolidated financial position, results of operations or cash flows.

## **Note 4 Net Income (Loss) Per Share**

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 8,895,287 and 6,651,029 shares of common stock were outstanding at March 31, 2004 and 2003, respectively. For the three months ended March 31, 2004, potentially dilutive securities consisted solely of options and resulted in potential common shares of 2,384,408. For the three months ended March 31, 2003, no potential common shares were included in the diluted per share amount as the effect would have been anti-dilutive. If potential common shares were included, the number of shares used to compute net loss per share would have been increased by approximately 945,094 shares for the three months ended March 31, 2003.



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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, 2004 and 2003, would have resulted in the pro forma amounts below:

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(in thousands, except per share amounts)</b>	
Net income (loss), as reported	\$ 299	\$ (1,560)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,011)	(767)
<b>Pro forma net loss</b>	<b>(712)</b>	<b>(2,327)</b>
Loss per share:		
Basic as reported	\$ 0.01	\$ (0.04)
Basic pro forma	\$ (0.01)	\$ (0.06)
Diluted as reported	\$ 0.01	\$ (0.04)
Diluted pro forma	\$ (0.01)	\$ (0.06)

**Note 5 Supplemental Balance Sheet Information**

Inventory consists of the following:

<b>(in thousands)</b>	<b>March 31, 2004</b>	<b>December 31, 2003</b>
Raw materials	\$ 24,061	\$ 13,587
Work-in-progress	650	1,477
Finished goods	15,607	12,683
	40,318	27,747
Valuation allowances	(1,343)	(1,043)
<b>Inventory, net</b>	<b>\$ 38,975</b>	<b>\$ 26,704</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.

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### **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 has not made any such estimate at this time since it is not probable there will be an unfavorable outcome.

### **Lexar Media, Inc. Patent Infringement**

The Company s lawsuit against Lexar Media for unfair trade practices in the United States District Court for the Central District of California was dismissed in August 2003. In connection with that lawsuit, Lexar Media filed on March 20, 2003 a counter claim against the Company alleging that the Memory Stick products sold by the Company violate Lexar Media s U.S. patent No. 5,479,638. Lexar Media is seeking monetary damages in an amount to be stated later, an injunction against further infringement of its patent, attorneys fees and trebled damages. The Company purchased Memory Stick products from I-O Data. Under the terms of the distribution agreement with I-O Data, I-O Data has agreed to indemnify, defend and hold the Company harmless from claims, damages, losses and costs which may arise from the alleged infringement by its products of third-party patents, trademarks or other proprietary rights. After initially agreeing to indemnify the Company and assume its defense, I-O Data failed to assume the Company s defense. As a result, the Company filed an answer to Lexar Media s counter claim and filed a Third Party Complaint against I-O Data asking for indemnification. In December of 2003, the Company settled its lawsuit with Lexar Media, who also dismissed the case against I-O Data. The Company has filed suit against I-O Data seeking recovery of damages, including those related to the Lexar Media case.

### **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 is seeking monetary damages in an amount to be stated later, an injunction against further infringement of its patent, attorneys fees and trebled damages. Staktek has answered the complaint denying infringement and alleging that the patent is invalid. No court dates have been set.

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 alleging that its IC Tower stacking products infringe on Staktek s U.S. patents Nos. 6,025,642 and 6,049,123. Staktek is seeking 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 have agreed to a mutual dismissal with prejudice of the intellectual property infringement lawsuits. In settlement of these matters, both parties have 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.

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### **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, 2004.

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, 2004.

### **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, 2004, 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 \$244,000 and \$234,000 in the three months ended March 31, 2004 and 2003, respectively.

### **Note 7 Segment Information**

The Company reports financial results for three reportable operating segments: Consumer, OEM and Xiran. The accounting policies for each of the reportable operating segments are the same as those described in Note 3 from the Company's Annual Report on Form 10-K and reflect the information used by the Company's management to evaluate the performance of its segments. For the Consumer and OEM segments, the Company tracks separately net sales and gross profit, but does not track separately operating expenses, interest or income taxes. For the Xiran segment, the Company currently tracks operating expenses only. The Company does not maintain separate records to identify assets by operating segment.

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

	<b>Three Months Ended March 31, 2004</b>				
<b>(in thousands)</b>	<b>Consumer</b>	<b>OEM</b>	<b>Subtotal</b>	<b>Xiran</b>	<b>Consolidated</b>
Net revenues	\$ 38,216	\$ 28,075	\$ 66,291	\$ 0	\$ 66,291
Cost of revenues	31,962	22,804	54,766	0	54,766
Gross profit	<u>\$ 6,254</u>	<u>\$ 5,271</u>	11,525	0	11,525
Operating expenses			8,845	2,426	11,271
Income from operations			<u>\$ 2,680</u>	<u>\$ (2,426)</u>	<u>\$ 254</u>

	<b>Three Months Ended March 31, 2003 (Revised Note 2)</b>				
<b>(in thousands)</b>	<b>Consumer</b>	<b>OEM</b>	<b>Subtotal</b>	<b>Xiran</b>	<b>Consolidated</b>
Net revenues	\$ 31,771	\$ 9,147	\$ 40,918	\$ 0	\$ 40,918
Cost of revenues	27,311	6,535	33,846	0	33,846
Gross profit	<u>\$ 4,460</u>	<u>\$ 2,612</u>	7,072	0	7,072
Operating expenses			8,099	1,874	9,973
Loss from operations			<u>\$ (1,027)</u>	<u>\$ (1,874)</u>	<u>\$ (2,901)</u>

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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.

**Revision of Financial Statements**

Our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the SEC on March 31, 2004 reflects revisions to our previously issued consolidated financial statements for the quarter ended March 31, 2003 for the following three items:

In December 2003, we discovered a non-cash clerical error in computing depreciation related to two fixed asset categories during the three-year period ended December 31, 2003. As a result of correcting this error, our operating expenses have been decreased by \$61,000 in the first quarter of 2003.

In the quarter ended June 30, 2003, we determined that the acquisition of Irvine Networks, LLC (now our Xiran Division) previously recorded as a business combination in the quarter ended March 31, 2002, should instead have been recorded as an acquisition of assets. As such, in our previously issued financial statements for the quarter ended June 30, 2003, we recorded the effect of correcting this accounting entirely in that quarter, rather than by revising our previously issued financial statements. As a consequence, in the quarter ended June 30, 2003, we previously (i) reclassified \$540,000 of the \$835,000 goodwill that had been recorded at the time of the transaction to amortizable intangible assets, representing assembled workforce with an estimated life of five years, (ii) charged-off against income the remaining \$295,000 of goodwill, and (iii) recorded amortization expense of \$162,000 reflecting the \$135,000 cumulative effect of related amortization since the date of the acquisition as well as \$27,000 in amortization for the quarter ended June 30, 2003. After further analysis, we have determined that the appropriate accounting would have been to retroactively reflect the effect of the asset acquisition for all periods since the date of acquisition. Consequently, we have revised our previously issued financial statements to primarily (i) increase by \$200,000, to \$1,560,000 the amount initially allocated to in-process research and development, (ii) increase by \$15,000, to \$115,000 the amount initially allocated to fixed assets, and (iii) allocate \$620,000 to assembled workforce, all as of the acquisition date in the quarter ended March 31, 2002. In addition, the goodwill write-off of \$295,000 and the cumulative amortization of \$135,000 relating to this transaction recorded in the quarter ended June 30, 2003, as well as the \$27,000 recorded for that quarter were reversed and instead the appropriate amortization charge of \$31,000 has been recorded in each quarter since the date of acquisition. As a result of correcting this error, operating expenses have been increased by \$31,000 in the quarter ended March 31, 2003.





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We have recorded in the quarter ended December 31, 2001 a write-down of \$141,000 of certain fixed assets, which were previously designated as held for sale in that quarter. Previously this write-down was recorded in the quarter ended March 31, 2003. As a result of correcting this error, cost of goods sold has been decreased by \$141,000 in the quarter ended March 31, 2003.

The combined effect of these revisions decreased our net loss by \$101,000 in the quarter ended March 31, 2003. Additionally, these revisions had no impact on fully diluted earnings per share in the quarter ended March 31, 2003.

The effect of the revisions described above on the first quarter of 2003 are as follows (in thousands, except per share data):

**Statement of Operations:**

<u>Year Ended:</u>	<u>March 31, 2003</u>	
	<u>As Reported</u>	<u>As Revised</u>
Gross Profit	\$ 6,931	\$ 7,072
Loss from operations	(3,072)	(2,901)
Net loss	(1,661)	(1,560)
Net (loss) income per share:		
Basic	\$ (0.04)	\$ (0.04)
Diluted	\$ (0.04)	\$ (0.04)

**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 solutions based on Flash and DRAM memory technologies. Headquartered in Santa Ana, California, SimpleTech offers a comprehensive line of over 2,500 products and specializes in developing high-density memory modules, memory cards and storage drives.

After we experienced revenue growth of 57.5% from 1998 to 1999 and 60.1% in 2000, revenues declined 46.7% in 2001. Revenues increased 7.5% in 2002 and 20.0% in 2003. Annual revenues in 2001 and 2002 were negatively impacted by deteriorating macroeconomic conditions, severe declines in the price of DRAM components and significantly reduced sales to customers in the communications and networking markets. These negative conditions began to improve during the second and third quarters of 2003 as demand for DRAM products increased and component prices stabilized. We believe that our improved results in the past four quarters may indicate a turnaround for our sector. However, there can be no assurance that Flash and DRAM demand or component prices will increase or remain stable or that a turnaround will occur or be sustained. We expect DRAM supply to continue to tighten in the second half of 2004, which may require suppliers to place their customers, ourselves included, on limited component allocation. In addition, we expect strong demand for our stacking and Flash product lines to continue through 2004.

We have experienced an increase in demand for our Flash products as the 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

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December 31, 1999 to \$80.3 million for the year ended December 31, 2003. Despite this growth, our revenues from Flash products in the fourth quarter of 2003 and the first quarter of 2004 were negatively impacted by Flash supply

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constraints. We believe the expected addition of new Flash suppliers in the industry and increased industry Flash capacity in the second half of 2004 will have a positive impact on our Flash revenues and gross margins as well as our competitiveness in the market.

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. We established our Xiran Division in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC, including its intellectual property portfolio. Our Xiran Division develops advanced board-level solutions that optimize server performance for networked storage applications, including IP storage. In the fourth quarter of 2003, our Xiran Division made its first shipments and generated nominal revenue in that quarter.

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, OEM and Xiran Divisions. We do not track separately, and do not intend to track separately, operating expenses for our Consumer and OEM Divisions. Conversely, we do track operating expenses for our Xiran Division.

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 59.2% of our total revenues in the first quarter of 2004 compared to 58.9% of our total revenues in the first quarter of 2003. 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. CDW Computer Centers accounted for 22.1% of our total revenues in the first quarter of 2003. Other than CDW Computer Centers, Micron Semiconductor and Smart Modular, no other customer accounted for more than 10.0% of our total revenues in the first quarter of 2004 and first quarter of 2003. 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 21.1% of our revenues in the first quarter of 2004 compared to 21.7% of our revenues in the first quarter of 2003. Except for Europe, which accounted for 12.5% of our revenues in the first quarter of 2003, no other foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in the first quarter of 2004 or first quarter of 2003. For each of the first quarters of 2004 and 2003, 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 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.

Revenues are recognized when title and risk of loss has passed to the customer. We face risks associated with declines in the market value of our products, product returns, inventory write-downs, price protection and rebates. See Risk Factors Order cancellations, product returns, inventory write-downs, price protection and rebates could adversely affect our results of operations.



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**Table of Contents****Results of Operations Three Months Ended March 31, 2004 Compared to Three Months Ended March 31, 2003**

*Net Revenues.* Our revenues were \$66.3 million in the first quarter of 2004, compared to \$40.9 million in the same period in 2003. Revenues increased 62.1% in the first quarter of 2004 due to a 63% increase in average sales price. Unit shipments were relatively flat. The increase in our average sales price resulted from higher average capacity products and a strong Flash and DRAM component pricing environment in the first quarter of 2004 compared to the first quarter of 2003. 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 increased 20.1% from \$31.8 million in the first quarter of 2003 to \$38.2 million in the first quarter of 2004. Consumer Division revenues increased in the first quarter of 2004 due to a 26% increase in Consumer Division average sales price, partially offset by a 5% decrease in Consumer Division unit volume. The increase in Consumer Division average sales price resulted from higher average capacity products and a strong Flash and DRAM component pricing environment in the first quarter of 2004 compared to the first quarter of 2003. Our OEM Division revenues increased 208.8% from \$9.1 million in the first quarter of 2003 to \$28.1 million in the first quarter of 2004. The increase in OEM Division revenues was due to a 171% increase in OEM Division average sales price in the first quarter of 2004 compared to the first quarter of 2003 and a 13% increase in OEM Division unit volume. OEM Division unit volume grew primarily due to a significant increase in the sale of IC Tower stacking products in the server and networking industries. The increase in OEM Division average sales price resulted from higher average capacity products and a strong Flash and DRAM component pricing environment in the first quarter of 2004 compared to the first quarter of 2003.

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 \$6.8 million as of March 31, 2004, compared to \$4.4 million as of March 31, 2003. Our Consumer Division backlog was \$1.3 million as of March 31, 2004, compared to \$1.5 million as of March 31, 2003. Our OEM Division backlog was \$5.5 million as of March 31, 2004, compared to \$2.9 million as of March 31, 2003. 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. We believe that our stronger than expected results in the first quarter of 2004, recent increases in DRAM and Flash demand along with the recent stabilization and increase of DRAM component prices may indicate a turnaround for our sector. However, there can be no assurance that Flash and DRAM demand or component prices will increase or remain stable or that a turnaround will occur or be sustained.

*Gross Profit.* Our gross profit was \$11.5 million in the first quarter of 2004, compared to \$7.1 million in the same period in 2003. Gross profit as a percentage of revenues was 17.4% in the first quarter of 2004, compared to 17.3% in the same period in 2003. Gross profit for our Consumer Division as a percentage of Consumer Division revenues was 16.4% in the first quarter of 2004, compared to 14.0% in the first quarter of 2003. Gross profit for our Consumer Division as a percentage of Consumer Division revenues for the first quarter of 2004 was positively impacted by a strong Flash and DRAM component pricing environment. Gross profit for our OEM Division as a percentage of OEM Division revenues was 18.8% in the first quarter of 2004, compared to 28.6% in the first quarter of 2003. This decrease in gross profit as a percentage of revenues for our OEM Division resulted primarily from a shift in product mix.

*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 \$5.6 million in the first quarter of 2004, compared to \$5.4 million in the same period in 2003. Sales and marketing expenses as a percentage of revenues were 8.4% in the first quarter of 2004, compared to 13.2% in the same period in 2003. Sales and marketing expenses increased due primarily to increased sales commissions and marketing programs resulting from expanded revenues in the first quarter of 2004 compared to the first quarter of 2003.



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*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 \$3.1 million in the first quarter of 2004, compared to \$2.5 million in the same period in 2003. General and administrative expenses as a percentage of revenues were 4.7% in the first quarter of 2004 and 6.1% in the first quarter of 2003. General and administrative expenses increased due primarily to increased payroll costs of \$254,000, legal fees of \$198,000 and insurance costs of \$69,000 in the first quarter of 2004 compared to the first quarter of 2003.

*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 \$2.5 million in the first quarter of 2004, compared to \$2.1 million in the same period in 2003. Research and development expenses as a percentage of revenues were 3.8% in the first quarter of 2004, compared to 5.1% in the same period in 2003. Research and development expenses increased due primarily to increased payroll costs and outside consulting fees in the first quarter of 2004 compared to the first quarter of 2003.

*Interest Income, Net.* Interest income, net was \$199,000 in the first quarter of 2004 and \$151,000 in the first quarter of 2003. 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 average cash, cash equivalents and marketable securities balance in the first quarter of 2004 compared to the first quarter of 2003.

*Provision (Benefit) for Income Taxes.* Provision for income taxes was \$154,000 in the first quarter of 2004. Benefit for income taxes was \$1.2 million in the first quarter of 2003. As a percentage of income (loss) before provision (benefit) for income taxes, provision (benefit) for income taxes was 34.0% in the first quarter of 2004 compared to (43.3)% in the first quarter of 2003. As a percentage of loss before benefit for income taxes, benefit for income taxes for the first quarter of 2003 reflected tax credits related to research and development and enterprise zone hiring credits. We expect quarterly research and development and enterprise zone hiring tax credits to be approximately \$100,000 to \$125,000 for the foreseeable future.

*Net Income (Loss).* Net income was \$299,000 in the first quarter of 2004, compared to a net loss of \$1.6 million in the first quarter of 2003.

## **Liquidity and Capital Resources**

As of March 31, 2004, we had working capital of \$115.6 million, including \$20.2 million of cash and cash equivalents and \$47.2 million in marketable securities, compared to working capital of \$114.1 million, including \$30.8 million of cash and cash equivalents and \$45.6 million in marketable securities as of December 31, 2003. Current assets were 5.6 times current liabilities at March 31, 2004, compared to 5.5 times current liabilities at December 31, 2003.

Net cash used in operating activities was \$9.1 million for the first quarter of 2004 and resulted primarily from a \$12.3 million increase in inventory, net of reserves, partially offset by a \$1.5 million decrease in accounts receivable, net of allowances, and \$892,000 in non-cash depreciation and amortization. Inventory, net of reserves, increased as a result of increased OEM Division orders, which have a longer lead time than Consumer Division orders, and a sharp increase in DRAM component prices near the end of the first quarter of 2004. Historically, higher DRAM component prices result in higher average selling prices and increased gross profit.

Net cash used in investing activities was \$1.7 million for the first quarter of 2004, attributable to \$1.6 million of investments in marketable securities and \$599,000 in purchases of furniture, fixtures and equipment, partially offset by \$525,000 in proceeds from the sale of furniture,

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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 provided by financing activities was \$165,000 for the first quarter of 2004 and resulted from the receipt of \$199,000 in proceeds from the issuance of common stock related to stock option exercises



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and purchases of stock by employees through the employee stock purchase plan, partially offset by \$34,000 in equity issuance costs.

We believe that our current assets, including cash and cash equivalents, expected cash flow from operations and proceeds received from our public offering received on October 29, 2003, will be sufficient to fund our operations 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 borrowing money or selling more stock to the public or to selected investors. 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;

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;

capital improvements to new and existing facilities;

technological advances; and

our competitors' response to our products.

## **Inflation**

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Inflation was not a material factor in either revenue or operating expenses during each of the first quarters of 2004 and 2003.

### **New Accounting Pronouncements**

In November 2002, the EITF reached a consensus on Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. This Issue provides guidance on when and how to separate elements of an arrangement that may involve the delivery or performance of multiple products, services and rights to use assets into separate units of accounting. The guidance in the consensus is effective for revenue arrangements entered into in fiscal periods, interim or annual, beginning after June 15, 2003. We adopted Issue No. 00-21 on July 1, 2003. The adoption of Issue No. 00-21 did not have a material impact to our consolidated financial position, results of operations, or cash flows.

In May 2003, the FASB issued SFAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS 150 establishes standards for how an issuer classifies

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and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003 (except for mandatory redeemable non-controlling interests). For all instruments that existed prior to May 31, 2003, SFAS 150 is effective at the beginning of the first interim period beginning after June 15, 2003 (except for mandatory redeemable non-controlling interests). For mandatory redeemable non-controlling interests, the FASB has deferred certain provisions of SFAS 150. The adoption of SFAS 150 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In December 2003 the SEC issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 codifies, revises and rescinds certain sections of SAB No. 101 in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. Accordingly, there is no impact to our results of operations, financial position or cash flows as a result of the issuance of SAB No. 104.

In December 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). FIN 46R requires the application of either FIN 46 or FIN 46R by Public Entities to all Special Purpose Entities (SPE) created prior to February 1, 2003 as of December 31, 2003 for calendar year-end companies. FIN 46R is applicable to all non-SPEs created prior to February 1, 2003 at the end of the first interim or annual period ending after March 15, 2004. For all entities created subsequent to January 31, 2003, Public Entities were required to apply the provisions of FIN 46. The adoption of FIN 46 did not have a material impact to our consolidated financial position, results of operations or cash flows. The adoption of FIN 46R for SPEs did not have an impact to our consolidated financial position, results of operations or cash flows, and we do not believe the adoption of FIN 46R for non-SPEs will have a material impact to our consolidated financial position, results of operations or cash flows.

## **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 generally 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 inventory excess, obsolescence and lower market values compared to costs and, when necessary, 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. 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. We estimate the impact of such pricing changes on a regular basis and adjust our allowances accordingly.



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*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 \$1.9 million for the first quarter of 2004 and \$2.2 million for the first quarter of 2003, respectively, of which \$1.2 million and \$1.0 million, respectively, were offset against revenues, and \$720,000 and \$1.2 million, 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.

*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 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.

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### **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;

The effects of litigation;

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;

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;

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

Expenses associated with the Xiran Division or any new 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.

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### **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 IC device supply contracts and only have a limited supply contract with Renesas, formerly Hitachi Semiconductor, for Flash IC devices. While some of our competitors have entered into long-term contracts with suppliers that guarantee them a certain allocation of Flash IC devices, our contract with Renesas provides no assurance that Renesas can or will agree to supply the quantities of Flash IC devices we may need to meet our production goals. In addition, our contract with Renesas will terminate in June 2004. 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, 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 revenues and could increase our costs or the prices of our products. In particular, if our supply relationships with Renesas or Samsung are disrupted or terminated, our ability to manufacture and sell our Flash products would be harmed and our Flash 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. The market for Flash IC devices is currently undergoing a period of limited supply, and we cannot predict if this condition will continue or worsen and, if it does, for how long. During this period of limited supply we have had to refuse to accept some orders from our customers for some of our products. 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.

### **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





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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 continue to 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. Since 2001, a downturn in the semiconductor industry has negatively impacted our average sales prices, revenues and earnings. These negative conditions continued through the first quarter of 2003, but began to improve in the second and third quarters of 2003 as demand for Flash and DRAM products increased and component prices stabilized. However, there can be no assurance that Flash and DRAM demand or component prices will increase or remain stable or that a turnaround will occur or be sustained. 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 59.2% of our total revenues in the first quarter of 2004 compared to 58.9% of our total revenues in the first quarter of 2003. Our ten largest Consumer Division customers accounted for an aggregate of 62.3% of our Consumer Division revenues, or 35.9% of our total revenues, in the first quarter of 2004 compared to 65.2% of our Consumer Division revenues, or 50.6% of our total revenues, in the first quarter of 2003. Our largest Consumer Division customer in each of the first quarters of 2004 and 2003, CDW Computer Centers, accounted for 31.2% of our Consumer Division revenues, or 18.0% of our total revenues, for the first quarter of 2004 compared to 28.5% of our Consumer Division revenues, or 22.1% of our total revenues, in the first quarter of 2003. No other Consumer Division customer accounted for more than 10.0% of our total revenues in each of the first quarters of 2004 or 2003.

Our ten largest OEM Division customers accounted for an aggregate of 82.3% of our OEM Division revenues, or 34.9% of our total revenues, in the first quarter of 2004 compared to 72.5% of our OEM Division revenues, or 16.2% of our total revenues, in the first quarter of 2003. Our two largest OEM Division 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%, 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 2004 or 2003.

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.



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

We have generated net operating losses and tax credits in recent years, which we are not fully able to utilize at this time. The availability of some of these net operating losses and tax credit carryforwards are subject to expiration and/or certain limitations. As of March 31, 2004, we had federal net operating loss carryforwards of approximately \$6.6 million, which begin to expire in 2023, and state net operating loss carryforwards of approximately \$5.5 million, which begin to expire in 2013. As of March 31, 2004, we had federal research and development credit carryforwards of approximately \$926,000, which begin to expire in 2022. In addition, we had the following state credits as of March 31, 2004: research and development credit carryforwards of approximately \$1.5 million, which carryforward indefinitely; enterprise zone credit carryforwards of approximately \$1.6 million, which carryforward indefinitely; and manufacturer's investment credit carryforwards of approximately \$498,000, which begin to expire in 2009. We are required to periodically review our ability to use our net operating loss and tax credit carryforwards. Such review may result in the limiting of the amount of net operating losses or tax credit carryforwards that can be utilized in the future to offset future taxable income or 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 net operating loss and tax credit carryforwards were substantially limited, it could harm our financial condition.

### **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.

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;

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Adverse effects on existing business relationships with suppliers and customers;

Risks associated with entering markets 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.

We completed the acquisition of the assets of Irvine Networks, LLC, renamed our Xiran Division, in January 2002. There can be no assurance that the product development efforts completed thus far by our Xiran Division will result in future profitability of the Xiran Division. In addition, the success of the Xiran Division will depend in significant part upon the ability to develop, introduce and sell its products on a timely and cost-effective basis, and to respond to changing customer requirements.

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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. In addition, 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 57.4% of our outstanding common stock at March 31, 2003. 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.**

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.



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### **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 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;



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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.

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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, DPAC Technologies, 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.

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

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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

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assurance that our future product development efforts, including the recent development by our Xiran Division of board-level solutions for servers designed to improve the efficiency and speed of data transport across a networking system, 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 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 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.

**Order cancellations, product returns, inventory write-downs, price protection and rebates could adversely affect our results of operations.**

To the extent we manufacture products in anticipation of future demand that does not materialize, or in the event a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory. A lack of consumer demand for our products may also cause increased product returns. A majority of our sales through consumer 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. We have had to write-down inventory

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in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were approximately \$315,000 in the first quarter of 2004 compared to \$25,000 in the first quarter of 2003. 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 approximately \$155,000 in the first quarter of 2004 compared to \$515,000 in the first quarter of 2003. We also offer rebate programs through some of our Consumer Division customers to end-users. We recorded rebate charges of \$0 in the first quarter of 2004, compared to \$353,000 in the first quarter of 2003.

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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, 2004, we have not 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 future. Sales under such agreements were approximately \$244,000 in the first quarter of 2004, compared to \$234,000 in the first quarter of 2003.

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.

**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 21.1% and 21.7% of our revenues in the first quarter of 2004 and 2003, respectively. Except for Europe, which accounted for 12.5% of our revenues in each of the first quarters of 2003, no other foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the first quarters of 2004 or 2003. For each of the first quarters of 2004 and 2003, 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.



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### **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 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 labors 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

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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.

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.

**Table of Contents****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, 2004, our cash and cash equivalents were \$20.2 million invested in money market and other interest bearing accounts.

At March 31, 2004, our investment in marketable securities was \$47.2 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, 2004, these marketable securities had a weighted-average time to maturity of approximately 70 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 \$202,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no 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.

The carrying amount, principal maturity and estimated fair value of our cash, cash equivalents and marketable securities as of March 31, 2004 were as follows:

	<u>Expected Maturity Date</u>			<u>Fair Value 3/31/2004</u>
	<u>Before April 1,</u>		<u>Total</u>	
	<u>2005</u>	<u>Thereafter</u>		
<b>Investments</b>				
Cash and cash equivalents:				
Money Market Funds	\$ 20,184,000	\$ 0	\$ 20,184,000	\$ 20,184,000
Weighted average interest rate	0.92%		0.92%	0.92%
Total cash and cash equivalents	\$ 20,184,000	\$ 0	\$ 20,184,000	\$ 20,184,000
Weighted average interest rate	0.92%		0.92%	0.92%
Marketable securities	\$ 47,233,000	\$ 0	\$ 47,233,000	\$ 47,233,000
Weighted average interest rate	1.17%		1.17%	1.17%

**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.

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**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 controls 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**

**DPAC Technologies, Inc. Patent Infringement**

On September 23, 1998, we filed a lawsuit against DPAC Technologies, Inc., formerly Dense-Pac Microsystems, Inc. in the United States District Court for the Central District of California for infringement of our IC Tower stacking patent, U.S. Patent No. 5,514,907. That patent was reissued on October 17, 2000 as U.S. Patent No. Re. 36,916. DPAC counterclaimed for infringement of its U.S. Patent No. 4,956,694. On March 29, 2001, the District Court entered final judgment finding DPAC did not infringe our patent and that we did not infringe DPAC's patent. The Appeals Court affirmed the final judgment as to SimpleTech's patent on March 7, 2002. DPAC did not appeal the ruling on its patent in our favor, and that ruling is now final. On June 3, 2002, we filed a petition for certiorari with the U.S. Supreme Court. On October 7, 2002, the petition to the U.S. 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 our patent. Subsequently, we filed the appropriate documents to seek review of the last decision.

On March 8, 2004, we entered into a confidential settlement agreement whereby we agreed to dismiss with prejudice our appeal of the case. Under the settlement, we 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**

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, and we have not made any such estimate at this time.

**Staktek Corporation Patent Infringement**

On July 30, 2003, we filed a lawsuit against Staktek Corporation in the United States District Court for the Central District of California for infringement of our IC Tower stacking patent, U.S. Patent No. Re. 36,916. We are seeking monetary damages in an amount to be stated later, an injunction against further infringement of our patent, attorneys' fees and trebled damages. Staktek has answered the complaint denying

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infringement and alleging that the patent is invalid. No court dates have been set.

On October 10, 2003, Staktek Group, L.P., a subsidiary of Staktek Corporation, filed a lawsuit against us in the United States District Court for the Western District of Texas alleging that our IC Tower stacking products infringe on Staktek's U.S. patents Nos. 6,025,642 and 6,049,123. Staktek is seeking 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. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative, and we have not made any such estimate at this time. No court dates have been set.

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On March 31, 2004, we resolved our two lawsuits with Staktek Group L.P. We have agreed with Staktek to a mutual dismissal with prejudice of the intellectual property infringement lawsuits. In settlement of these matters, both parties have 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.

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. CHANGES IN SECURITIES AND USE OF PROCEEDS**

None.

**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 AND REPORTS ON FORM 8-K**

(a) Exhibits.



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<b>Exhibit Number</b>	<b>Description</b>
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 specifically incorporates the foregoing information into those documents by reference.

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(b) Reports on Form 8-K.

We filed or furnished four reports on Form 8-K during our fourth quarter of 2003. Information regarding the items reported on is as follows:

<b><u>Date Filed or Furnished</u></b>	<b><u>Item No.</u></b>	<b><u>Description</u></b>
February 10, 2004*	7 and 12	On February 10, 2004, we issued a press release announcing our financial results for the fourth quarter and fiscal year ended December 31, 2003
March 12, 2004	5	On March 12, 2004, we announced the settlement of our two intellectual property infringement lawsuits with DPAC Technologies Corp.

\* In accordance with General Instruction B.6 of Form 8-K, the information in the Form 8-K and the exhibit attached thereto was not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), and shall not be subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report on Form 10-Q), unless the SimpleTech 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: April 28, 2004

SIMPLETECH, INC.,

a California corporation

/s/ MANOUCH MOSHAYEDI

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Manouch Moshayedi

Chief Executive Officer and Chairman of

the Board of Directors

Date: April 28, 2004

/s/ DAN MOSES

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Dan Moses

Chief Financial Officer (Principal

Financial and Accounting Officer)

and Director

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**SIMLETECH, INC.**

**Index to Exhibits**

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