SILICON STORAGE TECHNOLOGY INC
Form 10-Q
May 15, 2002

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

FORM 10-Q

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

For the quarterly period ended March 31, 2002

OR

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

For the transition period from _____to _____

Commission file number 0-26944

Silicon Storage Technology, Inc.

(Exact name of Registrant as Specified in its Charter)

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

1171 Sonora Court
Sunnyvale, California 94086
(Address of Principal Executive Offices including Zip Code)

(408) 735-9110
(Registrant's Telephone Number, Including Area Code)

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

Number of shares outstanding of our Common Stock, no par value, as of the latest practicable date, April 30, 2002: 92,315,727

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Part I -- FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Three Months Ended March 31,	
	2001	2002
	(unaudited)	(unaudited)
Net revenues:		
Product revenues - unrelated parties	$ 68,075	$ 30,657
Product revenues - related parties	11,854	35,638
License revenues	6,369	8,287
Total net revenues	86,298	74,582
Cost of revenues	57,358	50,502
Gross profit	28,940	24,080
Operating expenses:		
Research and development	12,286	11,872
Sales and marketing	6,344	7,504
General and administrative	4,808	3,317
Total operating expenses	23,438	22,693
Income from operations	5,502	1,387
Interest and other income	3,377	968
Interest expense	(99)	(64)
Income before provision for income taxes	8,780	2,291
Provision for income taxes	3,336	733
Net income	$ 5,444	$ 1,558
Net income per share - basic	$ 0.06	$ 0.02
Shares used in per share calculation	90,671	92,033
Net income per share - diluted	$ 0.06	$ 0.02
Shares used in per share calculation	96,424	97,000

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	December 31, 2001	March 31, 2002
	(unaudited)	(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 93,598	$ 97,471
Short-term available-for-sale investments	71,666	69,049
Trade accounts receivable-unrelated parties, net of allowance for doubtful accounts of $2,814 in 2001 and $2,746 in 2002	19,874	23,241
Trade accounts receivable-related parties	20,796	29,089
Inventories	108,224	91,321
Deferred tax asset	24,115	24,115
Other current assets	11,839	12,751
Total current assets	350,112	347,037
Equipment, furniture and fixtures, net	22,006	21,062
Long-term available-for-sale investments	1,299	12,138
Equity investments	67,007	67,007
Other assets	6,336	6,068
Total assets	$ 446,760	$ 453,312
LIABILITIES		
Current liabilities:		
Notes payable, current portion	$ 316	$ 325
Trade accounts payable-unrelated parties	24,098	25,114
Trade accounts payable-related parties	7,253	8,377
Accrued expenses and other liabilities	16,390	17,064
Deferred revenue	5,499	5,074
Total current liabilities	53,556	55,954
Other liabilities	1,793	1,613
Total liabilities	55,349	57,567
Commitments and Contingencies (Notes 5 and 6)		
SHAREHOLDERS' EQUITY		
Common stock, no par value:		
Authorized: 250,000 shares		
Issued and outstanding: 91,585 shares in 2001 and 92,311 shares in 2002	333,989	335,944

Accumulated other comprehensive income	225	1,046
Retained earnings	57,197	58,755
Total shareholders' equity	391,411	395,745
Total liabilities and shareholders' equity	$ 446,760	$ 453,312

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Three Months Ended March 31,	
	2001	2002
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net income	$ 5,444	$ 1,558
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation/amortization	2,274	2,509
Provision for doubtful accounts receivable	84	(68)
Provision for sales returns	--	3,024
Provision for excess and obsolete inventories and lower of cost or market	5,890	238
Loss on sale of equipment	35	--
Changes in operating assets and liabilities:		
Accounts receivable-unrelated parties	34,208	(6,323)
Accounts receivable-related parties	(11,060)	(8,293)
Inventories	(61,182)	16,665
Other current and non-current assets	(5,738)	(915)
Trade accounts payable-unrelated parties	14,178	1,016
Trade accounts payable-related parties	(50)	1,124
Accrued expenses and other current liabilities	(15,700)	171
Deferred revenue	10,032	(425)
Net cash provided by (used in) operating activities	(21,585)	10,281
Cash flows from investing activities:		
Investment in equity securities	(49,992)	--
Acquisition of equipment, furniture and fixtures	(6,961)	(1,294)
Purchases of available-for-sale investments	(27,508)	(27,383)
Sales and maturities of available-for-sale investments	38,260	20,485
Net cash used in investing activities	(46,201)	(8,192)
Cash flows from financing activities:		

Borrowings	1,800	--
Repayments	(46)	(76)
Issuance of shares of common stock	1,754	1,955
Other	(44)	(95)
Net cash provided by financing activities	3,464	1,784
Net increase (decrease) in cash and cash equivalents	(64,322)	3,873
Cash and cash equivalents at beginning of period	109,086	93,598
Cash and cash equivalents at end of period	$ 44,764	$ 97,471

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT MARCH 31, 2002

(UNAUDITED):

1. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed interim consolidated financial statements contain all adjustments, all of which are normal and recurring in nature, necessary to fairly present our financial position, results of operations and cash flows. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim periods or for the full fiscal year. These interim financial statements should be read in conjunction with the financial statements in our Annual Report on Form 10-K for the year ended December 31, 2001.

The year-end balance sheet at December 31, 2001 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We adopted SFAS No. 142 during the quarter ending March 31, 2002. The adoption of SFAS No. 142 did not have a significant impact on our financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for

Long-Lived Assets to be Disposed of." SFAS No. 144 applies to all long-lived assets, including discontinued operations, and consequently amends Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Division of a Business." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We adopted SFAS No. 144 during the quarter ending March 31, 2002. The adoption of SFAS No. 144 to date has not had a significant impact on our financial position or results of operations.

2. Computation of Net Income Per Share

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

	Three Months Ended March 31,	
	2001	2002
Numerator - Basic		
Net income	$ 5,444	$ 1,558
Denominator - Basic		
Weighted average common stock outstanding	90,671	92,033
Basic net income per share	$ 0.06	$ 0.02
Numerator - Diluted		
Net income	$ 5,444	$ 1,558
Denominator - Diluted		
Weighted average common stock outstanding	90,671	92,033
Dilutive potential of common stock equivalents:		
Options	5,753	4,967
	96,424	97,000
Diluted net income per share	$ 0.06	$ 0.02

Anti-dilutive stock options to purchase approximately 2,033,000 and 3,447,000 shares of common stock with weighted average prices of $21.31 and $16.72 were excluded from the computation of diluted net income per share for the three months ended March 31, 2001 and 2002, respectively, because the exercise price of these options exceeded the average fair market value of our common stock for the three months ended March 31, 2001 and 2002.

3. Marketable Securities

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

Our investments comprise federal, state, and municipal government obligations and foreign and public corporate debt securities. Investments with maturities of less than one year at the balance sheet date are considered short-term and investments with maturities greater than one year at the balance sheet date are considered long-term. All these investments are classified as available-for-sale and carried at fair value, based on quoted market prices, with the unrealized gains or losses, net of tax, reported in shareholders' equity as other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Realized gains and losses are recorded on the specific identification method. Realized gains and realized losses for the three months ended March 31, 2002 were not material.

An investment in King Yuan Electronics Company Limited, or KYE, a Taiwanese company that completed an initial public offering during 2001, has been included in "Long-term available-for-sale investments," and we have recorded the investment at fair market value, with unrealized gains and losses, net of tax, reported in shareholders' equity as other comprehensive income. If a loss is other than temporary, it is reported as an "Other operating expense." Dividends and other distributions of earnings from the investees, if any, are included in other income when declared.

The fair value of marketable securities as of March 31, 2002 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Fair Value
Corporate bonds and notes	$ 56,826	$ 12	$ 56,838
Foreign bonds and notes	5,387	20	5,407
Foreign listed equity securities	1,299	1,588	2,887
Government bonds and notes	59,801	67	59,868
Total bonds and notes	$ 123,313	$ 1,687	125,000
Less amounts classified as cash equivalents			(43,813)
Total short and long-term marketable securities			$ 81,187
Contractual maturity dates for investments in bonds and notes:			
Less than 1 year			$ 69,049
1 to 5 years			9,251
			$ 78,300

The unrealized gains as of March 31, 2002 are recorded in accumulated other comprehensive income, net of tax of $641,000.

The fair value of marketable securities as of December 31, 2001 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Fair Value
Corporate bonds and notes	$ 56,988	$ 59	$ 57,047
Foreign bonds and notes	5,418	49	5,467
Foreign listed equity securities	1,299	--	1,299

Government bonds and notes	58,944	255	59,199
Total bonds and notes	$ 122,649	$ 363	123,012
Less amounts classified as cash equivalents			(50,047)
Total short and long-term marketable securities			$ 72,965
Contractual maturity dates for investments in bonds and notes:			
Less than 1 year			$ 71,666

The unrealized gains as of December 31, 2001 are recorded in accumulated other comprehensive income, net of tax of $138,000.

4. Balance Sheet Detail

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

	December 31, 2001	March 31, 2002
Raw materials	$ 65,518	$ 48,768
Work in process	4,971	18,980
Finished goods	33,968	20,013
Consigned inventory	3,767	3,560
	$ 108,224	$ 91,321

Inventories are stated at the lower of cost, determined on a first-in, first-out basis, or market value. We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our

projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and have a significant impact on our financial position and results of operations. Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. While we have programs to minimize the required inventories on hand and we consider technological obsolescence when estimating allowances for potentially excess and obsolete inventories and those required to reduce recorded amounts to market values, it is reasonably possible that such estimates could change in the near term. Such changes in estimate could have a significant impact on our financial position and results of operations.

	December 31, 2001	March 31, 2002
Accrued compensation and related items	$ 4,372	$ 3,899
Accrued income tax payable	434	2,706
Accrued liabilities-related parties	764	768
Accrued warranty	2,883	1,650
Other accrued liabilities	7,937	8,041

$ 16,390	$ 17,064

5. Commitments

In December 2000, we committed, subject to certain business conditions, to prepay $50.0 million to a vendor in 2001 to secure increased wafer capacity in 2002 and 2003. In the second quarter of 2001, in response to weakening product demand and economic conditions, we renegotiated the commitment to defer the payment to late 2002. As of March 31, 2002, we had prepaid a total of $5.0 million towards this commitment, which is included in other current assets on the balance sheet. In addition, as of March 31, 2002, we had outstanding purchase commitments with our foundry vendors of approximately $32.0 million for delivery in 2002.

6. Contingencies

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

On two of the six patents, the District Court ruled by summary judgment that we did not infringe. Two of the other patents were invalidated by another U.S. District Court in a proceeding to which we were not a party, but this decision was later reversed by the Federal Circuit Court of Appeals. As discussed below, as the result of a ruling in another case, Atmel has withdrawn its allegations as to another patent ("the '747 patent"). At this point, three patents remain at issue in Atmel's District Court case against us ("the '811, '829 and '903 patents"). All of these patents have expired, so Atmel can no longer obtain an injunction against the sale of our products.

On February 17, 1997, Atmel filed an action with the International Trade Commission, or ITC, against two suppliers of our parts, involving four of the six patents that Atmel alleged that we infringe in the District Court case above. We intervened as a party to that investigation. Pursuant to indemnification agreements with these suppliers, we were obligated to indemnify both to the extent provided in those agreements. As more fully described below, the settlement with Winbond terminated our indemnity obligations to that company.

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

In a related action in 1997, Atmel filed a claim against Macronix alleging, among other things, that Macronix infringed the '747 patent. Because Atmel had filed a similar claim against us with regard to this same patent, we were permitted to intervene in the action and represent our interests in seeking to prevent Atmel from correcting inventorship. On January 14, 2002, the court in *Atmel Corp. v. Macronix America, Inc.* denied Atmel's motion to correct the '747 patent. As a result of the Court's decision, Atmel withdrew its claims against us based on the '747 patent.

A jury trial on the '811 and '829 patents began on April 8, 2002. The jury found that we willfully infringed those patents, and awarded Atmel $19,969,640 in actual damages. On May 7, 2002, the Court entered judgment in the total amount of $36,477,758, which includes the original $19,969,640. The '811 and '829 patents expired in February 2002.

Therefore, there will not be any impact on our ability to sell any of our products. We believe that there were significant errors in both the infringement and the damages verdicts, and intend to promptly appeal. We have not accrued any amount for this matter in the first quarter of 2002.

Trial on the '903 patent was severed and those issues will be tried in a later proceeding. That trial will determine whether the '903 patent is valid. The Court has ruled that we infringed that patent, so if the jury finds the patent valid, it will assess what, if any, damages are due Atmel. The Court has not indicated a schedule for that trial.

On October 1, 2000, we announced a settlement in our lawsuit with Winbond Electronics of Taiwan. We filed a lawsuit against Winbond in July 1998 in the U.S. District Court in San Jose, California pursuant to the termination of our SuperFlash technology licensing agreement with Winbond. As part of the settlement, Winbond agreed to a consent judgment and will not contest the validity and appropriateness of our termination of the licensing agreement in June 1998. This settlement concludes all litigation between us and Winbond. We received a total of $30.4 million in back royalties during 2000 and 2001 as part of this settlement in addition to royalties relating to products sold during 2001. No further back royalty payments are required after 2001 under this legal settlement.

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

7. Line of Credit

As of March 31, 2002, we had no borrowings on our line of credit of up to $35.0 million. Under the agreement, our borrowing is limited to 80.0% of eligible worldwide accounts receivable, and is also reduced by any letters of credit issued under our line of credit. As of March 31, 2002, there was approximately $455,000 outstanding in letters of credit and $8.8 million available under this line. The line bears interest at a rate of the bank's reference rate plus 0.5% (6.0% at March 31, 2002) with a minimum interest rate of 6.0%. Under the agreement, we are required to comply with certain covenants including maintaining a specified level of tangible net worth and we are not permitted to pay a dividend. We must pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of March 31, 2002, we were in compliance with the covenants of this agreement.

On April 11, 2002, we gave ninety-day written notice to our lender to terminate our line of credit under the agreement. In accordance with the terms of the agreement, we are not subject to any termination fees due to the fact that the early termination notice has occurred within six months of the expiration date in September 2002.

8. Segment Information

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

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

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

	Three Months Ended March 31, 2002	
	Revenues	Gross Profit
SMPG	$ 44,647	$ 8,840
ASPG	20,548	6,211
SPG	1,100	742
Technology Licensing	8,287	8,287
	$ 74,582	$ 24,080

	Three Months Ended March 31, 2001	
	Revenues	Gross Profit
SMPG	$ 50,337	$ 6,663
ASPG	27,855	15,312
SPG	1,737	596
Technology Licensing	6,369	6,369
	$ 86,298	$ 28,940

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family and certain custom products based on these standard flash memory families. These product families allow us to produce products optimized for cost, quality and functionality to support the broad range of applications that use nonvolatile memory products.

ASPG includes FlashBank, Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and LPC flash products. These products are designed to address specific applications such as cellular phones, pagers, PDAs, set-top boxes, hard disk drives and PC BIOS applications. It also includes flash embedded controllers and our mass data storage products such as the FlashFlex51 controller, the ATA controller, ADC, ADM, and CompactFlash Card product families, to address digital cameras, Internet appliances, PDAs, MP3 players, set-top boxes and other types of mass data storage applications.

SPG includes ComboMemory, ROM/RAM Combos, SRAM-related and other special flash products.

Technology Licensing includes both up front license fees and royalties.

9. Comprehensive Income

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

	Three Months Ended March 31,

	2001	2002
Net income	$ 5,444	$ 1,558
Other comprehensive income:		
Change in net unrealized gains on investments, net of tax	72	821
Total comprehensive income	$ 5,516	$ 2,379

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

	December 31, 2001	March 31, 2002
Net unrealized gains on investments, net of tax	$ 225	$ 1,046

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

The following discussion may be understood more fully by reference to the consolidated financial statements, notes to the consolidated financial statements, and management's discussion and analysis of financial condition and results of operations contained in our Annual Report on Form 10-K for the year ended December 31, 2001, as filed with the Securities and Exchange Commission.

The following discussion contains forward-looking statements, which involve risk and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors which are difficult to forecast and can materially affect our quarterly or annual operating results. Fluctuations in revenues and operating results may cause volatility in our stock price. Please refer to the section below entitled "Business Risks".

Overview

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

The semiconductor industry has historically been cyclical, characterized by wide fluctuations in product supply and demand. From time to time, the industry has also experienced significant downturns, often in connection with, or in anticipation of, production over-capacity and declines in general economic conditions. Downturns of this type occurred in 1996, 1997 and 1998 and more recently in late 2000 and 2001. These downturns have been characterized by weakening product demand, excessive inventory and accelerated decline of selling prices, and in some cases have lasted for more than a year. We began to experience a sharp downturn in several of our markets late in the fourth

quarter of 2000, as our customers reacted to weakening demand for their products. Since the second half of 2001, we have seen a positive change in order activities for our products for DVD players, CD-RW drives, PDAs and video games, as well as the continued strong shipment from the second quarter in our products for PCs and graphics cards. Unit shipments for these market segments continued to grow in the first quarter of 2002. In addition, for the first time since the fourth quarter of 2000, we noted unit growth in sales of our products for the networking and wireless communications market segments, particularly in the cordless phone, the wireless modem and the wireless LAN applications. Our business could be harmed by industry-wide fluctuations in the future.

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

We derived 77.6%, 80.7% and 89.6% of our product revenues during 2000, 2001 and the three months ended March 31, 2002, respectively, from product shipments to Asia. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia.

Our top ten end customers, which excludes transactions through stocking representatives and distributors, accounted for 19.3%, 31.5% and 41.5% of our net product revenues in 2000, 2001 and the three months ended March 31, 2002, respectively.

No single end customer, which we define as original equipment manufacturers, or OEMs, original design manufacturers, or ODMs, contract electronic manufacturers, or CEMs, or end users, represented 10.0% or more of our net product revenues during 2000, 2001 and the three months ended March 31, 2002.

Since March 2001, we have been out-sourcing our customer service logistics in Taiwan to Silicon Professional Technology Ltd., or SPT. SPT is a wholly owned subsidiary of one of our stocking representatives in Taiwan, Professional Computer Technology Limited, or PCT. SPT provides planning, warehousing, delivery, billing, collection and other logistic functions for us in Taiwan. SPT now services substantially all of our end customers based in Taiwan and selected end customers throughout Asia. Products shipped to SPT are accounted for as consigned inventory, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. For the year ended December 31, 2001 and the three months ended March 31, 2002, SPT serviced end customer sales accounting for 30.3% and 52.0% of our net product revenues recognized, respectively. We are in the process of working with SPT to expand their service coverage to include all of our end customers in China and Southeast Asia.

We ship products to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, domestic distributors, and our logistics center. Our stocking representatives, domestic distributors and logistics center reship our products to our end customers, including OEMs, ODMs, CEMs and end users. No stocking representative or domestic distributor serviced more than 10.0% of our end customer sales in 2000, 2001 or the three months ended March 31, 2002.

As of December 31, 2001, SPT, our logistics center, represented 48.8% of our accounts receivable and Actron Technology Co., or Actron, a stocking representative, represented 21.9% of our accounts receivable. As of March 31, 2002, SPT, represented 54.7% of our accounts receivable and Actron represented 10.9% of our accounts receivable.

Results of Operations: Quarter Ended March 31, 2002

Net Revenues

Net revenues were $74.6 million for the first quarter of 2002 as compared to $70.8 million in the fourth quarter of 2001 and $86.3 million for the first quarter of 2001. Revenues decreased compared to the first quarter of last year due to decreased average selling prices, offset by increased shipment volume of our products. Revenues for the first quarter of 2002 increased compared to the prior quarter due to an increase in volume of units shipped, offset by decreased average selling prices for our products. Our quarterly results are not indicative of annual results. Average selling prices fluctuate due to a number of factors including the overall supply and demand for our products in the marketplace, maturing product cycles and general economic conditions. We began to experience a sharp downturn in several of our markets late in the fourth quarter of 2000, as our customers reacted to weakening demand for their products. Since the second half of 2001 we have seen a positive change in order activities in our products for DVD players, CD-RW drives, PDAs and video games, as well as the continued strong shipment in our products for desktop PCs and graphics cards. Unit shipments for these market segments continued to grow in the first quarter of 2002. In addition, for the first time since the fourth quarter of 2000, we noted unit growth in sales of our products for the networking and wireless communications market segments, particularly in the cordless phone, the wireless modem and the wireless LAN applications.

Product Revenues

. Product revenues were $66.3 million in the first quarter of 2002 as compared to $60.6 million in the fourth quarter of 2001 and $79.9 million for the first quarter of 2001. Product revenues decreased compared to the first quarter of last year due to decreased average selling prices for our products by approximately 49.1%, offset by increased shipment volume of our products by approximately 50.1%. Product revenues increased compared to the fourth quarter of 2001 due to increased shipment volume of our products by approximately 12.1%, offset by decreased average selling prices for our products by approximately 7.6%. Shipping volumes fluctuate due to overall industry supply and demand.

License Revenues. Revenues from license fees and royalties were $8.3 million in the first quarter of 2002, as compared to $10.2 million in the fourth quarter of 2001 and $6.4 million in the first quarter of 2001. During 2001 Winbond paid us $5.0 million per quarter for a total of $20.0 million under a settlement agreement. In addition to the settlement payments Winbond continues to pay royalties. The increase from the first quarter of 2001 to the first quarter of 2002 was primarily due to license fees paid and recognized under our license agreements, including up-front payments from NEC and milestone payments from Motorola associated with their respective agreements. The decrease from the fourth quarter of 2001 to the first quarter of 2002 was primarily because Winbond has completed its final installment payment in the fourth quarter of 2001 according to the terms of our legal settlement. We anticipate that license revenues may fluctuate significantly in the future.

Gross Profit

Gross profit was $24.1 million, or 32.3% of net revenues, in the first quarter of 2002 as compared to gross profit of $10.3 million, or 14.5% of net revenues, in the fourth quarter of 2001 and $28.9 million, or 33.5% of net revenues, in the first quarter of 2001. The increase in gross profit from the fourth quarter of 2001 to the first quarter of 2002 relates to the favorable impact on the current period resulting from inventory valuation adjustments made in 2001 and an increase in product revenues from the fourth quarter of 2001 to the first quarter of 2002 due to increased volume of units shipped, offset by decreased average selling prices. The decrease in gross profit in the first quarter of 2002 when compared to the first quarter of 2001 is due primarily to decreases in average selling prices. Product gross margin was 23.8% for the first quarter of 2002, compared to 0.2% for the fourth quarter of 2001 and 28.2% for the first quarter of 2001. The increase in product gross margin from the fourth quarter of 2001 to the first quarter of 2002 relates to the favorable impact on the current period resulting from inventory valuation adjustments made in 2001 and increased shipment volume of our products by approximately 12.1%, offset by decreased average selling prices for our products by approximately 7.6%. The decrease in product gross margin from the first quarter of 2001 to the first quarter of 2002 relates to decreased average selling prices of our products by approximately 49.1%, offset by increased shipment volume of our products by approximately 50.1%.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, and general and administrative expenses. Operating expenses were $22.7 million, or 30.4% of net revenues, in the first quarter of 2002, compared to $26.0 million, or 36.7% of net revenues, in the fourth quarter of 2001, and $23.4 million, or 27.2% of net revenues, in the first quarter of 2001. The slight decrease from the comparable quarter last year was due to cost containment measures. The decrease from the fourth quarter of 2001 was due primarily to a $3.3 million charge for an "other than temporary" decline in the value of a publicly held equity investment and $590,000 expense for impairment of intangible assets which we recorded in the fourth quarter of 2001. Excluding the non-recurring charges, operating expenses increased only 2.6% from the fourth quarter of 2001 to the first quarter of 2002. This increase related primarily to increased commissions due to increased product revenue and increased legal expenses. We anticipate that we will continue to devote substantial resources to research and development, sales and marketing and to general and administrative, and that these expenses will continue to increase.

Research and development

. Research and development expenses include costs associated with the development of new products, enhancements to existing products, quality assurance activities and occupancy costs. These costs consist primarily of employee salaries and benefits, and the cost of materials such as masks, wafers and evaluation parts. Research and development expenses were $11.9 million, or 15.9% of net revenues, during the first quarter of 2002, as compared to $12.1 million, or 17.1% of net revenues, during the fourth quarter of 2001 and $12.3 million, or 14.2% of net revenues, during the first quarter of 2001. Research and development expenses decreased by 1.7% from the fourth quarter of 2001 and by 3.4% from the first quarter of 2001 due primarily to a decrease of approximately $224,000 and $518,000 in non-production engineering material expenses in the first quarter of 2002 as compared to the prior quarter and the same quarter of last year, respectively. We expect research and development expenses to increase as we continue to invest in new product offerings, drive to new deep sub-micron technologies and reduce costs associated with our existing products.

Sales and marketing

. Sales and marketing expenses consist of commissions, headcount and related costs, as well as travel and entertainment and promotional expenses. Sales and marketing expenses were $7.5 million, or 10.1% of net revenues, in the first quarter of 2002, as compared to $7.2 million, or 10.1% of net revenues, in the fourth quarter of 2001 and $6.3 million, or 7.4% of net revenues, during the first quarter of 2001. The increase in sales and marketing expenses from the fourth quarter of 2001 to the first quarter of 2002 was primarily attributable to increased bonus accruals relating to sales and design win activity by approximately $200,000 and increased commission expenses by approximately $142,000 due to higher revenues in the first quarter of 2002. The increase in sales and marketing expenses from the first quarter of 2001 to the first quarter of 2002 was primarily attributable to increased headcount and related costs by approximately $868,000 and increased costs related to patent and intellectual property support by approximately $330,000. We expect sales and marketing expenses to increase as we continue to expand our sales and marketing efforts. In addition, fluctuations in revenues will cause fluctuations in sales and marketing expenses as it impacts our commission expenses.

General and administrative.

General and administrative expenses consist of salaries and related costs for administrative, executive and finance personnel, recruiting costs, professional services and legal fees and allowances for doubtful accounts. General and administrative expenses were $3.3 million, or 4.4% of net revenues, in the first quarter of 2002, as compared to $2.9 million, or 4.0% of net revenues, in the fourth quarter of 2001 and $4.8 million, or 5.6% of net revenues, during the first quarter of 2001. Expenses increased from the fourth quarter of 2001 due to increased headcount and related costs by approximately $206,000 and legal costs related to the Atmel litigation of approximately $273,000. The decrease in

general and administrative expenses from the first quarter of 2001 was primarily due to a decrease in our legal expense related to the Atmel litigation of approximately $942,000. We anticipate that general and administrative expenses will continue to increase as we scale our facilities, infrastructure, and headcount to support our overall expected growth. We may also incur additional expenses in connection with the Atmel litigation. For further information on this litigation see "Legal Proceedings."

Interest and other income.

Interest and other income was approximately $1.0 million, or 1.3% of net revenues, during the first quarter of 2002, as compared to $1.1 million, or 1.6% of net revenues, during the fourth quarter of 2001 and $3.4 million, or 3.9% of net revenues, during the first quarter of 2001. Interest income decreased from the fourth quarter of 2001 to the first quarter of 2002 due to decreasing interest rates on invested cash. Interest income decreased from the first quarter of 2001 to the first quarter of 2002 due to a decrease in cash, cash equivalents and available-for-sale investments balances and decreasing interest rates on invested cash.

Interest Expense.

Interest expense was approximately $64,000 for the first quarter of 2002 as compared to $73,000 for the fourth quarter of 2001 and $99,000 for the first quarter of 2001. Interest expense relates to interest and fees under our line of credit. Fees will continue and will fluctuate depending on our use of the line of credit facility.

Provision for (Benefit from) Income Taxes

Our income tax provision of $733,000 in the first quarter of 2002 is based on a 32.0% tax rate on income before taxes. This compares with a tax benefit of $5.6 million in the fourth quarter of 2001 which is based on a 38.0% tax rate on loss before taxes and a tax provision of $3.3 million in the first quarter of 2001 which is based on a 38.0% tax rate on income before taxes. We expect our effective tax rate to be 32.0% for the remainder of 2002. Our tax rate may change depending on our profitability and the timing of the implementation of certain tax planning strategies.

Segment Reporting

Our operations involve the design, development, manufacturing, marketing and technical support of our nonvolatile memory products. We offer low and medium density devices that target a broad range of existing and emerging applications in the digital consumer, networking, wireless communications and Internet computing markets. Our products are differentiated based upon attributes such as density, voltage, access speed, package and predicted endurance. We also license our technology for use in non-competing applications. Our reportable segments are: the Standard Memory Product Group, or SMPG, the Application Specific Product Group, or ASPG, the Special Product Group, or SPG, and Technology Licensing. Refer to Note 8 to the Condensed Consolidated Financial Statements for revenue and gross profit information by reportable segment. Our analysis of the changes for each segment is discussed below.

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family and certain custom products based on these standard flash memory families. These families allow us to produce products optimized for cost and functionality to support the broad range of applications that use nonvolatile memory products. SMPG revenues were $44.6 million for the first quarter of 2002, as compared to $36.3 million in the fourth quarter of 2001 and $50.3 million in the first quarter of 2001. The increase in revenues from the fourth quarter of 2001 was primarily due to increased unit shipments offset by lower average selling prices. The decrease in revenues from the first quarter of 2001 was primarily due to decreased average selling prices offset by increased unit shipments. Gross margin increased from negative 14.7% in the fourth quarter of 2001 to 19.8% in the first quarter of 2002 primarily due to the favorable impact on the current period resulting from inventory valuation adjustments made in 2001 and increased

unit shipments offset by lower average selling prices. Gross margin increased from 13.2% in the first quarter of 2001 to 19.8% in the first quarter of 2002 primarily due to increased unit shipments offset by lower average selling prices.

ASPG includes FlashBank, Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and LPC flash products. These products are designed to address specific applications such as cellular phones, pagers, PDAs, set-top boxes, hard disk drives and PC BIOS applications. ASPG also includes flash embedded controllers and our mass data storage products such as the FlashFlex51, ADC, ADM, and CompactFlash Card product families, to address digital cameras, Internet appliances, PDAs, MP3 players, set-top boxes and other types of mass data storage applications. ASPG revenues were $20.5 million for the first quarter of 2002, as compared to $22.7 million in the fourth quarter of 2001 and $27.9 million in the first quarter of 2001. The decrease in revenues from both the first and fourth quarters of 2001 was primarily due to lower average selling prices offset by increased unit shipments. Gross margin increased slightly from 29.9% in the fourth quarter of 2001 to 30.2% in the first quarter of 2002 primarily due to increased unit shipments offset by lower average selling prices, and decreased inventory valuation adjustments to cost of sales during the first quarter of 2002. Gross margin decreased from 55.0% in the first quarter of 2001 to 30.2% in the first quarter of 2002 primarily due to lower average selling prices.

SPG includes ComboMemory, ROM/RAM Combos, SRAM-related and other special flash products. SPG revenues were $1.1 million for the first quarter of 2002, as compared to $1.6 million in the fourth quarter of 2001 and $1.7 million in the first quarter of 2001. The decrease in revenues from both the first and fourth quarters of 2001 was primarily due to lower average selling prices offset by increased unit shipments. Gross margin increased from negative 81.0% in the fourth quarter of 2001 to 67.4% in the first quarter of 2002 and from 34.3% in the first quarter of 2001 to 67.4% in the first quarter of 2002 primarily due to changes in unit shipment mix and average selling prices.

Revenue and gross profit related to Technology Licensing was $8.3 million for the first quarter of 2002, $10.2 million for the fourth quarter of 2001 and $6.4 million for the first quarter of 2001.

Related Party Transactions

The following table is a summary of our related party revenues and purchases for the quarter ended March 31, 2002, and our related party accounts receivable and payable balances as of March 31, 2002 (in thousands). For a description of our relationship with these parties please see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2001.

	Three Months Ended March 31, 2002		March 31, 2002	
	Revenues	Purchases	Accounts Receivable	Accounts Payable and Accruals
Silicon Technology Co., Ltd.	$ 473	$ --	$ 112	$ --
Acer and related entities (1)	341	266	246	300
Apacer Technology, Inc.	194	50	90	56
Professional Computer Technology Limited	141	--	--	383
Silicon Professional Technology Ltd.	34,489	--	28,641	973
King Yuan Electronics Company, Limited	--	3,608	--	3,922
Powertech Technology, Incorporated	--	2,600	--	3,511
	$ 35,638	$ 6,524	$ 29,089	$ 9,145

(1) Excludes Apacer Technology balances

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

Critical Accounting Policies

For information related to our revenue recognition and other critical accounting policies, please refer to the "Critical Accounting Policies" section of our Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2001, as filed with the Securities and Exchange Commission.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We adopted SFAS No. 142 during the quarter ending March 31, 2002. The adoption of SFAS No. 142 did not have a significant impact on our financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." SFAS No. 144 applies to all long-lived assets, including discontinued operations, and consequently amends Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Division of a Business." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We adopted SFAS No. 144 during the quarter ending March 31, 2002. The adoption of SFAS No. 144 to date has not had a significant impact on our financial position or results of operations.

Liquidity and Capital Resources

Operating activities.

Our operating activities generated cash of $10.3 million for the three months ended March 31, 2002 as compared to using cash of $21.6 million for the three months ended March 31, 2001. The cash provided by operating activities for the three months ended March 31, 2002 related primarily to net income of $1.6 million, non-cash adjustments of $5.7 million, primarily relating to provision for sales returns of $3.0 million and depreciation and amortization of $2.5 million, decreases in inventory of $16.7 million and increases in trade accounts payable from related and unrelated parties of $2.1 million. Cash provided by operating activities was reduced by an increase of $14.6 million in trade accounts receivable from related and unrelated parties, an increase of $915,000 in other current and non-current assets and a decrease of $425,000 in deferred revenue. Increased accounts receivable from related and unrelated parties relates to increased shipment volume offset by decreased average selling prices. The cash used in operating activities for the three months ended March 31, 2001 related primarily to increases in accounts receivable from related parties of

$11.1 million, inventory of $61.2 million, other current and non-current assets of $5.7 million and a decrease in accrued expenses and other current liabilities of $15.7 million. The cash used in operating activities were offset by net income of $5.4 million, non-cash adjustments of $8.3 million, a decrease in accounts receivable from unrelated parties of $34.2 million and decreases in trade accounts payable from related parties of $14.2 million and in deferred revenue of $10.0 million.

Investing activities.

Our investing activities used cash of $8.2 million for the first quarter of 2002, as compared to using cash of $46.2 million for the first quarter of 2001. Investing activities in the first quarter of 2002 were primarily related to net purchases of available-for-sale investments of $6.9 million and capital expenditures of approximately $1.3 million. In the first quarter of 2001, investing activities were primarily related to a $50.0 million equity investment in Grace Semiconductor Manufacturing Corporation, a Cayman Islands company with operations in China, as a part of multi-phased strategic plan to expand our market presence into China and approximately $7.0 million spent in capital expenditures, offset by net sales and maturities of available-for-sale investments of approximately $10.8 million.

Financing activities.

Our financing activities provided cash of approximately $1.8 million during the first quarter of 2002 as compared to $3.5 million for the first quarter of 2001. For the first quarter of 2002, the cash provided was from $2.0 million of common stock issued under the employee stock purchase plan and the exercise of employee stock options, offset by $171,000 in loan repayments and other. The cash provided for first quarter of 2001 was primarily from the issuance of common stock for $1.8 million and $1.8 million related to a loan from a landlord, offset by $90,000 in loan repayments and other.

Principal sources of liquidity at March 31, 2002 consisted of $178.7 million of cash, cash equivalents, short and long-term available-for-sale investments and the line of credit. As of March 31, 2002 we had no borrowings on our line of credit of up to $35.0 million. Under the agreement, our borrowing is limited to 80.0% of eligible worldwide accounts receivable and is also reduced by any letters of credit issued under our line of credit. As of March 31, 2002 there was approximately $455,000 outstanding in letters of credit and $8.8 million available under this line. The line bears interest at a rate of the bank's reference rate plus 0.5% (6.0% at March 31, 2002) with a minimum interest rate of 6.0%. Under the agreement, we are required to comply with certain covenants, including maintaining a specified level of tangible net worth and we are not permitted to pay a dividend. We must also pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of March 31, 2002, we were in compliance with the covenants of this agreement.

On April 11, 2002, we gave ninety-day written notice to our lender to terminate our line of credit under the agreement. In accordance with the terms of the agreement, we are not subject to any termination fees due to the fact that the early termination notice has occurred within six months of the expiration date in September 2002.

Purchase Commitments.

In December 2000, we committed, subject to certain business conditions, to prepay $50.0 million to a vendor in 2001 to secure increased wafer capacity in 2002 and 2003. In the second quarter of 2001, in response to weakening product demand and economic conditions, we renegotiated the commitment to defer the payment to late 2002. As of March 31, 2002, we had prepaid a total of $5.0 million towards this commitment, which is included in other current assets on the balance sheet. In addition, as of March 31, 2002, we had outstanding purchase commitments with our foundry vendors of approximately $32.0 million for delivery in 2002.

Lease Commitments. We have long-term, non-cancelable building lease commitments. We are currently seeking subtenants for our unused office space. We may be unable to secure subtenants, for this space, due to the recent

decrease in demand for commercial rental space in Silicon Valley. See also "Business Risks - If we are not successful in subleasing our unused office space, we may be required to take a period charge for the difference between the total future sublease income and our lease cost."

Future payments due under building lease and purchase commitments as of March 31 (in thousands):

	Building Lease	Purchase Commitments	Total
2002	$ 3,657	$ 77,046	$ 80,703
2003	4,980	--	4,980
2004	5,131	--	5,131
2005	3,563	--	3,563
2006	2,434	--	2,434
Thereafter	8,471	--	8,471
	$ 28,236	$ 77,046	$ 105,282

Stock Purchase Plan. In September 2001, our board of directors authorized the purchase of an aggregate of up to $15.0 million of our common stock. The purchases may be made in the open market at prevailing market prices or in negotiated transactions off the market, subject to compliance with applicable provisions of the California Corporations Code and in accordance with applicable federal and state securities laws and regulations. The stock purchase program will continue until September 30, 2002 unless earlier revoked by the board of directors. As of March 31, 2002, no shares had been purchased under this program.

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

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

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

Business Risks

Risks Related to Our Business

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

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

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

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

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

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

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

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

We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. As of March 31, 2002, we had $91.3 million of inventory on hand, a decrease of $16.9 million, or 15.6%, from December 31, 2001. Total valuation adjustments to inventory were $72.2 million in 2001. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and could harm our financial results.

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

Due to possible customer changes in delivery schedules and cancellations of orders, our backlog at any particular date is not necessarily indicative of actual sales for any succeeding period. A reduction of backlog during any particular period, or the failure of our backlog to result in future revenue, could harm our business. We began to experience a sharp downturn in several of our markets late in the fourth quarter of 2000, as our customers reacted to weakening demand for their products. Although we had improvements in total units shipped since the second half of 2001, our revenues declined in first quarter of 2002 when compared to first quarter of 2001 due to decreased average selling prices. Our business could be harmed by industry-wide fluctuations in the future.

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

During 2000, 2001 and first quarter of 2002, our export product and licensing revenues accounted for approximately 84.3%, 90.3% and 90.9% of our net revenues, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would harm our operating results. These risks include:

- difficulties in complying with regulatory requirements and standards;
- tariffs and other trade barriers;
- costs and risks of localizing products for foreign countries;

- reliance on third parties to distribute our products;
- extended accounts receivable payment cycles;
- potentially adverse tax consequences;
- limits on repatriation of earnings; and
- burdens of complying with a wide variety of foreign laws.

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

We derived 77.6%, 80.7% and 89.6% of our net product revenues from Asia during 2000, 2001 and first quarter of 2002, respectively. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia. Any kind of economic, political or environmental instability in this region of the world can have a severe negative impact on our operating results due to the large concentration of our production and sales activities in this region. For example, during 1997 and 1998, several Asian countries where we do business, such as Japan, Taiwan and Korea, experienced severe currency fluctuation and economic deflation, which negatively impacted our revenues and also negatively impacted our ability to collect payments from customers. During this period, the lack of capital in the financial sectors of these countries made it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks. Finally, the economic situation during this period exacerbated a decline in selling prices for our products as our competitors reduced product prices to generate needed cash.

It should also be noted that we are greatly impacted by the political, economic and military conditions in Taiwan. Taiwan and China are continuously engaged in political disputes and both countries have continued to conduct military exercises in or near the other's territorial waters and airspace. Such disputes may continue and even escalate, resulting in an economic embargo, a disruption in shipping or even military hostilities. Additionally, we believe the economic uncertainty fueled by the September 11, 2001 terrorist attacks in the United States has caused our customer base to become more cautious. Any of these events could delay production or shipment of our products. Any kind of activity of this nature or even rumors of such activity could harm our operations, revenues, operating results, and stock price.

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

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

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

We rely on stocking representatives, distributors and our logistics center to establish and maintain customer relationships and to sell our products. These stocking representatives, distributors and our logistics center could discontinue their relationship with us or discontinue selling our products at any time. The majority of our stocking representatives and our logistics center are located in Asia.

Since March 2001, we have been out-sourcing our customer service logistics in Taiwan to Silicon Professional Technology Ltd., or SPT. SPT is a wholly owned subsidiary of one of our stocking representatives in Taiwan, Professional Computer Technology Limited, or PCT. SPT provides planning, warehousing, delivery, billing, collection and other logistic functions for us in Taiwan. SPT now services substantially all of our end customers based in Taiwan and selected end customers throughout Asia. Products shipped to SPT are accounted for as consigned inventory, and revenue is recognized when the products have been delivered and are considered as a sale to our end

customers by SPT. For the year ended December 31, 2001 and the three months ended March 31, 2002, SPT serviced end customer sales accounting for 30.3% and 52.0% of our net product revenues recognized, respectively.

Product shipments to Asia accounted for 77.6%, 80.7% and 89.6% of net product revenues for 2000, 2001 and the three months ended March 31, 2002, respectively. For further description of our relationships with PCT and SPT, please refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation - Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2001.

We ship to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, domestic distributors, and our logistics center. Our logistics center, stocking representatives and domestic distributors reship our products to our end customers, including OEMs, ODMs, CEMs and end users. No stocking representative or domestic distributor serviced more than 10.0% of our customer sales in 2000 or 2001.

No single customer, which we define as an OEM, ODM, CEM, or end user that purchases product directly from us or through our logistics center, represented 10.0% or more of our net product revenues during 2000, 2001 and the three months ended March 31, 2002.

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

The loss of our relationship with any of these stocking representatives, logistics center or distributors, or any other significant stocking representative or distributor could harm our operating results by impairing our ability to sell our products to our end customers.

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

We outsource substantially all of our manufacturing and testing activities. We currently buy all of our wafers and sorted die from a limited number of suppliers. Substantially all of our products are manufactured by four foundries, TSMC in Taiwan, Sanyo and Seiko-Epson in Japan, and Samsung in Korea. We anticipate that these foundries, together with Nanya and Vanguard in Taiwan and Oki in Japan, will manufacture the majority of our products in 2002. On March 6, 2001, we invested $50.0 million in GSMC, a Cayman Islands company, for a wafer foundry project located in Shanghai, China. We anticipate that GSMC will begin to manufacture some of our products in early 2003. If these suppliers fail to satisfy our requirements on a timely basis at competitive prices we could suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of which could harm our operating results.

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

If we are unable to increase our manufacturing capacity, our revenues may decline.

In order to grow, we need to increase our present manufacturing capacity. Events that we have not foreseen could arise which would limit our capacity. We have a remaining commitment to prepay a total of $45.0 million in late 2002, subject to certain economic and business conditions, to secure increased wafer capacity in 2002 and 2003. We

are continually engaged in attempting to secure additional manufacturing capacity to support our long-term growth. Similar to our $50.0 million investment in GSMC, we may determine that it is necessary to invest substantial capital in order to secure appropriate production capacity commitments. If we cannot secure additional manufacturing capacity on acceptable terms, our ability to grow will be impaired and our operating results will be harmed.

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

We have long-term, non-cancelable building lease commitments. We are currently in the process of locating subtenants for our unused office space. We may be unable to secure subtenants, for this space, due to the recent decrease in demand for commercial rental space in Silicon Valley. During the third quarter of 2001, we recorded a period charge to other operating expense of approximately $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge is an estimate as of March 31, 2002 and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. If we are unable to secure subtenants, we may be required to take additional period charges for the balance of the future lease cost, and this will harm our operating results.

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

future.

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

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

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

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

Our wafer and product requirements typically represent a small portion of the total production of the foundries that manufacture our products. As a result, we are subject to the risk that a foundry will cease production on an older or lower-volume manufacturing process that it uses to produce our parts. Additionally, we cannot be certain our foundries will continue to devote resources to advance the process technologies on which the manufacturing of our products is based. Each of these events could increase our costs and harm our ability to deliver our products on time.

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

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

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

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

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

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

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

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

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

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

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

The markets for our products are characterized by:

- rapidly changing technologies;

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

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

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

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

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

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

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

We rely on a combination of patent, trade secrets, copyrights, mask work rights, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Policing unauthorized use of our products, however, is difficult, especially in foreign countries. Litigation may continue to be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition regardless of the outcome of the litigation. We own 44 patents in the United States relating to our products and processes, and have filed for several more. In addition, we hold several patents in Europe and Canada, and have filed several foreign patent applications in Europe, Japan, Korea, Taiwan and Canada. We cannot assure you that any pending patent application will be granted. Our operating results could be harmed by the failure to protect our intellectual property.

If we are accused of infringing the intellectual property rights of other parties we may become subject to time-consuming and costly litigation. If we lose, we could suffer a significant impact on our business and be forced to pay damages.

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

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

In addition to the Atmel, Intel and Winbond actions, we receive from time to time, letters or communications from other companies stating that such companies have patent rights that involve our products. Since the design of all of our products is based on SuperFlash technology, any legal finding that the use of our SuperFlash technology infringes the patent of another company would have a significantly negative effect on our entire product line and operating results. Furthermore, if such a finding were made, there can be no assurance that we could license the other company's technology on commercially reasonable terms or that we could successfully operate without such technology. Moreover, if we are found to infringe, we could be required to pay damages to the owner of the protected technology and could be prohibited from making, using, selling, or importing into the United States any products that infringe the protected technology. In addition, the management attention consumed by and legal cost associated with any litigation could harm our operating results.

Public announcements may hurt our stock price.

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

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

Whether or not we are successful in our lawsuit with Atmel, we expect this litigation to continue to consume substantial amounts of our financial and managerial resources. A jury recently found that we willfully infringed Atmel's '811 and '829 patents, and awarded Atmel $19,969,640 in actual damages. On May 7, 2002, the Court entered judgment in the total amount of $36,477,758, which includes the original $19,969,640. The '811 and '829 patents expired in February 2002. Therefore, there will not be any impact on our ability to sell any of our products. We

believe that there were significant errors in both the infringement and the damages verdicts, and intend to promptly appeal. We have incurred certain amounts associated with defending this matter, and at any time Atmel may file additional claims against us, which could increase the risk, expense and duration of the litigation. Further, because of the substantial amount of discovery required in connection with this type of litigation, there is a risk that some of our confidential information could be compromised by disclosure. For more information with respect to our litigation, please also see "Part II, Item 1- Legal Proceedings."

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

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

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

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

Our growth continues to place a significant strain on our management systems and resources and if we fail to manage our growth, our ability to market, sell our products or develop new products may he harmed.

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

Risks Related to Our Industry

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

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

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

The semiconductor industry has historically been cyclical, characterized by wide fluctuations in product supply and demand. From time to time, the industry has also experienced significant downturns, often in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. Downturns of this type occurred in 1997 and 1998, and more recently in late 2000 and 2001. These downturns are characterized by diminished product demand, production over-capacity and accelerated decline of average selling prices, and in some cases have lasted for more than a year. Our business could be harmed by industry-wide fluctuations in the future. The flash memory products portion of the semiconductor industry, from which we derive substantially all of our revenues suffered from excess capacity in 1996, 1997 and 1998, which resulted in greater than normal declines in our markets, which unfavorably impacted our revenues, gross margins and profitability. While these conditions improved in 1999 and 2000, deteriorating market conditions at the end of 2000 and continuing through the first quarter of 2002 have resulted in the decline of our selling prices and harmed our operating results.

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

Sales of our products in the consumer electronics applications market are subject to seasonality. As a result, sales of these products are impacted by seasonal purchasing patterns with higher sales generally occurring in the second half of each year. In 1999 and the first half of 2000, this seasonality was partially offset by the introduction of new products as we continued to diversify our product offerings. In 2001, this seasonality again became pronounced as it was combined with deteriorating market conditions, which together resulted in sequential quarter to quarter declines in product revenues from the fourth quarter of 2000 through the second quarter of 2001, and lower sales in the second half of 2001. If we fail to continue to introduce new products, our business may suffer and the seasonality of a portion of our sales may become more pronounced.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufacturing and sales activities. These exposures may change over time as business practices evolve and could negatively impact our operating results and financial condition. All of our sales are denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore reduce the demand for our products. Such a decline in the demand could reduce revenues and/or result in operating losses. In addition, a downturn in the economies of China, Japan or Taiwan could impair the value of our equity investments in companies with operations in these countries. If we consider the value of these companies to be impaired, we will write off, or expense, some or all of our investments. In the fourth quarter of 2001, we wrote down our investment in KYE by $3.3 million due to an other than temporary decline in its market value. At March 31, 2002, the recorded value of our KYE investment was approximately $2.9 million, which represented the fair market value as of the balance sheet date. We also have equity investments in companies with operations in China, Japan and Taiwan with recorded values at March 31, 2002 of approximately $50.0 million, $0.9 million and $16.1 million, respectively.

At any time, fluctuations in interest rates could effect interest earnings on our cash, cash equivalents and available-for-sale investments, any interest expense owed on the line of credit facility, or the fair value of our investment portfolio. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. As of March 31, 2002, the carrying value of our marketable securities approximated fair value. The table below presents the carrying value and related weighted average interest rates for our cash, cash equivalents and available-for-sale investments as of March 31, 2002 (in thousands).

	Carrying Value	Interest Rate
Short-term investments - fixed rate	$ 69,049	3.2%
Long-term investments - fixed rate	9,251	2.6%
Cash and cash equivalents - variable rate	97,471	1.1%
	$ 175,771	2.0%

PART II

Item 1. Legal Proceedings

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

On two of the six patents, the District Court ruled by summary judgment that we did not infringe. Two of the other patents were invalidated by another U.S. District Court in a proceeding to which we were not a party, but this decision was later reversed by the Federal Circuit Court of Appeals. As discussed below, as the result of a ruling in another case, Atmel has withdrawn its allegations as to another patent ("the '747 patent"). At this point, three patents remain at issue in Atmel's District Court case against us ("the '811, '829 and '903 patents"). All of these patents have expired, so Atmel can no longer obtain an injunction against the sale of our products.

On February 17, 1997, Atmel filed an action with the International Trade Commission, or ITC, against two suppliers of our parts, involving four of the six patents that Atmel alleged that we infringed in the District Court case above. We intervened as a party to that investigation. Pursuant to indemnification agreements with these suppliers, we were obligated to indemnify both to the extent provided in those agreements. As more fully described below, the settlement with Winbond terminated our indemnity obligations to that company.

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

In a related action in 1997, Atmel filed a claim against Macronix alleging, among other things, that Macronix infringed the '747 patent. Because Atmel had filed a similar claim against us with regard to this same patent, we were

permitted to intervene in the action and represent our interests in seeking to prevent Atmel from correcting inventorship. On January 14, 2002, the court in *Atmel Corp. v. Macronix America, Inc.* denied Atmel's motion to correct the '747 patent. We intervened as a party in the Macronix case for purposes of opposing that motion. As a result of the Court's decision, Atmel withdrew its claims against us based on the '747 patent.

A jury trial on the '811 and '829 patents began on April 8, 2002. The jury found that we willfully infringed those patents, and awarded Atmel $19,969,640 in actual damages. On May 7, 2002, the Court entered judgment in the total amount of $36,477,758, which includes the original $19,969,640. The '811 and '829 patents expired in February 2002. Therefore, there will not be any impact on our ability to sell any of our products. We believe that there were significant errors in both the infringement and the damages verdicts, and intend to promptly appeal. We have not accrued any amount for this matter in the first quarter of 2002.

Trial on the '903 patent was severed and those issues will be tried in a later proceeding. That trial will determine whether the '903 patent is valid. The Court has ruled that we infringed that patent, so if the jury finds the patent valid, it will assess what, if any, damages are due Atmel. The Court has not indicated a schedule for that trial.

On October 1, 2000, we announced a settlement in our lawsuit with Winbond Electronics of Taiwan. We filed a lawsuit against Winbond in July 1998 in the U.S. District Court in San Jose, California pursuant to the termination of our SuperFlash technology licensing agreement with Winbond. As part of the settlement, Winbond agreed to a consent judgment and will not contest the validity and appropriateness of our termination of the licensing agreement in June 1998. This settlement concludes all litigation between us and Winbond. We received a total of $30.4 million in back royalties during 2000 and 2001 as part of this settlement in addition to royalties relating to products sold during 2001. No further back royalty payments are required after 2001 under this legal settlement.

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

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

(a)&#9*Exhibits.* We incorporate by reference all exhibits filed in connection with our annual report on Form 10-K for the year ended December 31, 2001.

(b)&#9Reports on Form 8-K filed during the quarter ended March 31, 2002: None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, County of Santa Clara, State of California, on the 15th day of May, 2002.

SILICON STORAGE TECHNOLOGY, INC.

(Registrant)

By: /s/ BING YEH
Bing Yeh
President and Chief Executive Officer
(Principal Executive Officer)

By: /s/ JEFFREY L. GARON
Jeffrey L. Garon
Vice President Finance & Administration,
Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)