SIMPLETECH INC
Form 10-K
March 16, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO

SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2004

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 000-31623

SIMPLETECH, INC.

(Exact Name of Registrant as Specified in Its Charter)

California	**33-0399154**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

3001 Daimler Street

Santa Ana, California 92705-5812

(Address of principal executive offices, including zip code)

Registrant s Telephone Number, Including Area Code: (949) 476-1180

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, $0.001 par value	The Nasdaq National Market

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

Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

As of June 30, 2004, the last business day of the registrant s most recently completed second fiscal quarter, the approximate aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant was $69,610,500 (based upon the last closing price for shares of the registrant s common stock as reported by The National Market System of the National Association of Securities Dealers Automated Quotation System as of that date). Shares of common stock held by each officer, director, and holder of 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 1, 2005, there were approximately 45,972,401 shares of common stock outstanding.

Documents Incorporated By Reference

Certain information required in Part III hereto is incorporated by reference to the Proxy Statement for the Registrant s 2005 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Form 10-K.

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SIMPLETECH, INC.

FORM 10-K ANNUAL REPORT

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This Annual Report on Form 10-K, including information incorporated herein by reference, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements relate to expectations concerning matters that are not historical facts. Words such as projects, believes, anticipates, will, estimate, plans, expects, intends, and similar words and expressions are intended to identify forward-looking statements. Although we believe that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. Important language regarding factors which could cause actual results to differ materially from such expectations are disclosed in this Report, including without limitation under the caption Risk Factors beginning on page 14 of this Report. All forward-looking statements attributable to SimpleTech are expressly qualified in their entirety by such language. We do not undertake any obligation to update any forward-looking statements.

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PART I.

ITEM 1. BUSINESS

Overview

SimpleTech designs, manufactures and markets custom and open-standard memory solutions based on Flash memory and dynamic random access memory, or DRAM, technologies as well as external hard drive storage solutions. We offer a comprehensive line of more than 2,500 products and specialize in developing high-density memory modules, memory cards and storage drives. One way that we distinguish ourselves in the marketplace is by offering Flash and DRAM-based memory solutions and external hard drive storage solutions used by consumers and original equipment manufacturers, or OEMs. We believe this allows us to service a diverse customer base with multiple memory formats thereby enabling our customers to purchase all of their memory requirements from one supplier.

The growth in demand for consumer electronic devices such as digital cameras, MP3 digital audio players, personal digital assistants, or PDAs, digital camcorders and smart phones, as well as the increased memory requirements of these devices, has helped fuel the increased use of non-volatile data storage Flash memory, or NAND Flash. NAND Flash is the preferred technology for these applications because it is lightweight, durable, rugged, compact and retains data without power. Our Flash cards store digital content such as pictures, digital music, video clips and files in a small form factor with large storage capacity and low power consumption. We offer our Flash cards in all major media formats, including CompactFlash, Secure Digital and MultiMedia cards. In addition to the demand in consumer markets, our Flash business is also expanding as a result of the growing number of OEM applications in which Flash drives are replacing rotating disk drives due to improved performance, reliability and size. These OEM applications include military subsystems, in-flight information systems, casino-gaming systems, embedded controls for industrial automation and medical equipment. According to Web-Feet Research in a report dated March 2005, NAND Flash industry revenues are expected to grow from $7.4 billion in 2004 to $16.6 billion in 2007.

Our DRAM products target primarily high-performance computing applications, including switches, routers, high-end servers, workstations, desktops and notebooks. As the applications that we serve expand and as the complexity of these applications increases, the need for the customization of our products in these applications also increases. We have developed proprietary technologies to address the increased need for customized solutions. For example, our patented IC Tower® stacking technology allows multiple memory chips to be stacked together to increase the capacity of a memory module without expanding its footprint. This technique increases memory board density significantly over conventional techniques and is particularly well-suited for applications where high memory capacity, cost and space are critical. We have recently experienced growing demand for our IC Tower stacking products driven by our increased penetration of the server market. We believe this technology allows our customers to design memory-intensive systems on a differentiated and more price competitive basis. We also believe the growth of the DRAM market will be driven primarily by the next PC upgrade cycle, the demand for increased memory content per PC and a resumption of IT spending. According to SIA in a report dated November 2004, the DRAM industry is expected to grow from $26.9 billion in 2004 to $30.1 billion in 2007.

Our various storage products are designed to address the increasing need for expanded, reliable digital storage. The storage product line consists of the following five categories: (1) SimpleShare, the Network Attached Storage product category that enables users to add shared storage to a network, (2) SimpleDrive, the desktop external storage product category which enables fast, reliable back-up and expanded storage volumes, (3) SimpleDrive Portable, the mobile storage product category which enables truly mobile back-up storage, (4) SimpleTransfer, the data migration product category that permits efficient data transfer among multiple PCs and (5) notebook hard drive upgrades.

The essence of the SimpleTech storage product family is fast, reliable storage and back up capabilities for desktop or notebook computers so that users can create media libraries for their digital music, movies and photographs, or add gigabytes of additional storage to accommodate expanding storage needs. According to Coughlin Associates, the 3.5 inch and portable external storage industry is expected to grow from $1.4 billion in 2004 to $3.2 billion in 2007.

We offer memory and external hard drive storage solutions through our Consumer and OEM Divisions. Our Consumer Division sells open-standard memory and storage products such as Flash cards, DRAM modules, USB mini drives and hard disk drives which are used primarily as upgrades in consumer electronic devices and computing systems. We believe our comprehensive line of products allows our customers to efficiently manage their inventory purchases and therefore reduce their costs by consolidating their purchases of memory and storage products into a single vendor. Our OEM Division sells primarily customized memory solutions for newly-manufactured systems, with most sales based on a cooperative design effort between our design engineers and our OEM customers. We believe the ability of these equipment manufacturers to shorten product development cycles and accelerate time-to-market is critical to

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their success. In response to this trend, we believe equipment manufacturers are increasingly outsourcing the design, development and manufacturing of memory products to third-party memory providers, such as SimpleTech. We believe our design, manufacturing, testing and logistics expertise, along with our proprietary technologies, enable us to respond quickly to our customers rapidly changing product and service requirements as well as meet their time-to-market schedules.

Industry Background

The memory market can be divided into several types of integrated circuit (IC) devices that are designed to perform specific functions within computer and other electronic devices or systems. Two of the major types of memory products are Flash and DRAM. Flash is considered a non-volatile memory since it is able to retain data without a power source. Since DRAM requires a constant power supply to retain data, it is considered volatile memory. DRAM has historically dominated the memory industry in terms of market size and scale of production and continues to be one of the highest volume semiconductors manufactured today. In recent years, the memory market has expanded to include Flash due to the proliferation of consumer electronic devices designed to allow increasing user mobility. The growth in shipments of these consumer electronic devices and their unique and expanding storage requirements have led to the increased demand for Flash memory products.

The Flash memory industry is divided into two primary segments: data storage, or NAND, and code storage, or NOR. Data storage Flash products are commonly used for storing large volumes of data in small form factor and in environments characterized by high levels of shock, vibration or temperature fluctuation. In contrast, code storage Flash products are typically used in less memory-intensive applications. Substantially all of our Flash product revenues are derived from the sale of data storage Flash products. Data storage Flash products are used primarily to store digital content such as pictures, digital music, video clips and files in consumer electronic devices such as digital cameras, MP3 digital audio players, PDAs, digital camcorders and smart phones. The demand for these consumer electronic devices has grown rapidly. In addition, these consumer electronic devices have become smaller in size while requiring increasing amounts of memory which is driving the demand for high-density, small form factor Flash memory solutions. Flash memory is noiseless, considerably lighter, more rugged and consumes substantially less power than a rotating disk drive. These characteristics also make Flash drives a better storage alternative than rotating disk drives in extreme environments such as those often found in the military, aerospace and communication applications.

The DRAM industry growth is driven by unit growth in the markets for PCs, high-performance workstations, servers, switches, routers and the Internet infrastructure. In addition, DRAM growth is fueled by an increasing amount of memory content used in these systems. We also anticipate that the expected PC replacement cycle and resumption of IT spending will continue to drive the demand for DRAM memory.

The Flash and DRAM memory supply chain consists of numerous participants including semiconductor manufacturers, third-party module and card manufacturers and a variety of distributors and mass market retailers who sell to end-users. Major memory semiconductor manufacturers have focused primarily on large volume opportunities, producing open-standard modules and cards as base-level memory for the leading OEMs of desktops and notebooks, digital cameras, cell phones and other mass markets. In contrast to serving the base-level memory needs of these OEMs, third-party module and card manufacturers, such as SimpleTech, provide open-standard upgrades used by consumers. In addition, we believe the increasing complexity of computing systems as well as the demands placed on them has caused OEMs to rely increasingly on third-party design and manufacturing of custom memory products in which open-standard modules and cards are not adequate.

External storage industry growth is driven primarily by the trend of increasing requirements to store digital music, movies and photographs and the desire for reliable back up for these digital files. Our storage solutions enable fast, user-friendly, back up and retrieval of such files and certain products allow users to add shared storage to their network.

The SimpleTech Solution

SimpleTech designs, manufactures and markets a comprehensive line of memory and storage products used in consumer electronics, high-performance computing, defense and aerospace systems, networking and communications and other OEM applications. We believe our comprehensive line of products allows our customers to efficiently manage their supply chains by consolidating their memory and storage product purchases.

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Product Features

High degree of customization. Products sold to our OEM Division customers are typically customized by our design and engineering teams to meet our customers specific design requirements.

High density. Our patented stacking technology allows us to design and manufacture Flash cards and DRAM memory modules in which multiple memory chips are stacked together to increase the capacities of memory modules without increasing the product footprint. In some cases, our IC Tower stacking memory technology allows us to create a high capacity solution that is otherwise not currently available in the market using standard modules, and in other cases it allows us to provide the same capacity as a standard module at a lower price point.

Compact size. We are able to manufacture high-density Flash and DRAM memory products with some of the smallest footprints on the market. As component chips increase in capacity, we are able to increase density in the same footprint.

High performance and reliability. Our memory products are built utilizing sophisticated error detection and correction processes to provide high data reliability and integrity. In addition, our memory products are designed to withstand high levels of shock and vibration as well as extreme temperature fluctuations typically associated with mobile computing and OEM applications.

Low power consumption. During read and write operations, Flash memory products typically use less power than rotating disk drives. At all other times during system operation, Flash memory products require no power. This low power consumption translates into longer battery life for many mobile computing and consumer electronic devices.

Consumer Division

Our Consumer Division sells open-standard memory storage products such as Flash cards, DRAM modules, USB mini drives and hard disk drives used as upgrades in or enhancements to consumer electronics and computing systems. Our Consumer Division customers sell our products through the following channels: value added reseller, or VAR, mail order, distributor, and mass market retailer. We believe we are able to strengthen our relationships with these Consumer Division customers and develop the SimpleTech brand name through various marketing programs, such as volume purchase rebates, joint marketing, account manager incentives and lead generation. We also provide ongoing customer support, including on-line pricing and navigation tools, toll-free technical support and account manager training programs.

OEM Division

Our OEM Division sells primarily customized memory solutions for newly-manufactured systems, with most sales based on a cooperative design effort between our design engineers and our OEM customers. We offer our OEM Division customers a comprehensive technology solution from concept to design to the creation of prototypes through volume production and testing. We believe our quick-turn design capabilities and automated manufacturing and test processes allow our OEM Division customers to quickly and cost-effectively bring products to market. In addition, our capabilities allow our OEM Division customers to focus their resources on activities and technologies in which they add the greatest value, such as system design, sales, marketing and distribution. We believe our technical capabilities and manufacturing strengths allow our OEM Division customers to cost-effectively design and implement advanced memory chip technology in high-volume product applications.

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Products

We offer a comprehensive line of more than 2,500 memory and storage products using our proprietary design and manufacturing technologies. Substantially all of our Flash and DRAM memory products comply with industry standards and are based on a variety of industry architectures. Sales of Flash memory and DRAM products accounted for substantially all of our total revenues in 2004 and 2003. The balance is composed of sales of storage products.

Flash Products

Our Flash products are commonly used as portable digital media in consumer applications, including electronic devices such as digital cameras, mobile phones, MP3 digital audio players and PDAs, and as replacements for hard disk drives in industrial applications, such as military systems and network infrastructure equipment. Our Flash products are compatible with the majority of today s industry standards.

We offer a broad line of Flash products in various form factors and capacities, including:

CompactFlash memory cards. CompactFlash products provide full PC Card AT Attachment (ATA) functionality but are only one-fourth the size of a standard PC Card. CompactFlash s small size, durability, low power consumption and ability to operate at either 3.3 volts or 5.0 volts make it well-suited for a range of current and next-generation, small size consumer applications such as audio recorders, digital cameras, MP3 digital audio players and PDAs. CompactFlash products provide interoperability with systems based on the PC Card ATA standard by using a low-cost passive adapter.

Secure Digital and MultiMediaCard Flash memory cards. Secure Digital, or SD, and MultiMediaCard, or MMC, Flash memory cards are used in data storage applications and are about the size of a postage stamp. Their slim, compact design makes them an ideal removable storage solution for designs including mobile phones**,** audio players, digital cameras, and PDAs.

miniSD and Reduced-size MultiMedia cards. miniSD and reduced-size MMC, or RS-MMC, Flash memory cards are designed to meet the demanding storage needs of the growing mobile phone and handheld device market. MiniSD and RS-MMC easily convert into standard SD and MMC cards with an adapter to provide interoperability with existing SD and MMC card slots, adding functionality for digital still cameras, MP3 music players, digital camcorders and PDAs that use standard SD and MMC cards.

USB Flash drives. Our USB Flash drive portfolio consists of the embedded Bonzai Xpress and the upgradeable Bonzai which utilizes either an SD or MMC Flash memory card. The Bonzai Xpress is available in a broad range of fixed capacities of up to 2 gigabytes (GB). In contrast, the Bonzai offers greater capacity options since users can easily replace or upgrade the SD or MMC Flash memory card to enable the use of multiple Flash memory cards on the same Bonzai, upgrade of the Bonzai to higher storage capacities and the use of a single Flash drive among multiple devices. Our USB Flash drives are primarily replacements for floppy disk drives, with performance differentiators being ease of use, longer rewrite life, and scalability. The presence of USB ports on most desktops and laptops makes portable, pocket-sized USB Flash drives a convenient device to store, transfer and carry personal files.

ATA Flash PC cards. Our ATA Flash PC Cards are used in storage, data backup and data logging applications. Our products are available in the industry standard PC Card Type II form factor.

Solid State Drives. Our solid state drives are designed to meet the data storage requirements of a wide range of industries, including the defense and aerospace, automotive and transportation, industrial and communications industries. They are drop-in replacements for traditional hard drives and are a superior substitute for hard drives in systems that require sustained operation in harsh environments, low-power consumption, content security, fast data transfer speeds, and high-capacity storage. Typical applications include data recorders, rugged PCs, industrialized servers, telecommunications equipment, and other mission-critical applications. Our solid state drives are available in standard hard drive form factors and interfaces, such as Integrated Drive Electronics/AT Attachment (IDE/ATA) in a 2.5-inch case.

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Flash disk modules. Our Flash disk module products target embedded systems where device footprint is a critical parameter. There is no electrical circuitry or software interface change required when replacing a standard hard drive with a Flash disk module. The main benefit of Flash disk modules is that they are easier to incorporate into designs because they are less than one-quarter the size of a 2.5-inch hard drive and they plug directly into the motherboard, thereby eliminating the need for cables. Specifically, the product line is available in a 44-pin configuration, which addresses similar functionality to a 2.5-inch hard disk drive, and a 40-pin configuration, which addresses similar functionality to a 3.5-inch hard disk drive.

The following table describes certain of our Flash modules as of March 1, 2005:

Data Storage Flash Product Family	Density	Form Factor
CompactFlash	32MB 8GB	Type I (36.4mm x 42.8mm x 3.3mm)
Secure Digital	32MB 1GB	9-pin
MultiMediaCard	16MB 512MB	7-pin
Bonzai Xpress	128MB 2GB	USB Flash drive
Bonzai	32MB 1GB	Upgradeable USB Flash drive
ATA Flash PC Cards	64MB 8GB	Type II (54.0mm x 85.6mm x 5.0mm)
Solid-State Drives	32MB 128GB	2.5 inch, 3.5 inch and custom
Flash Disk Modules 40-pin	64MB 2GB	40-pin vertical & horizontal; 40-pin low profile horizontal
Flash Disk Modules 44-pin	64MB 2GB	44-pin vertical & horizontal

DRAM Products

We offer a full range of DRAM products, including single in-line memory modules (SIMMs), dual in-line memory modules (DIMMs) and small-outline (SO) DIMMs. Our DRAM products are used primarily in higher performance computing, communications, and industrial applications. Our standard DRAM products are available in various memory module form factors and densities of up to 4GBs. We also offer many of these products utilizing different DRAM architectures such as DDR, DDR2, SDRAM, RDRAM, and legacy products such as EDO and FPM.

The following table describes certain of our non-stacking DRAM products as of March 1, 2005:

DRAM Product Family	Density	Architecture	Speed (MHz)
184-pin and 240-pin DIMM	64MB 4GB	DDR, DDR2	266 667
200-pin SO DIMM	64MB 1GB	DDR, DDR2	266 533
Rambus DIMM	64 512MB	RDRAM	600 1066
168-pin, 184-pin and 240-pin Registered DIMM	64MB 4GB	SDRAM, DDR, DDR2	66 667
168-pin DIMM	16 256MB	EDO, FPM	100 133
144-pin SO DIMM	16MB 1GB	SDRAM, EDO, FPM	100 133
100-pin DIMM	16 64MB	SDRAM, EDO, FPM	100 133
72-pin SO DIMM	16 64MB	EDO, FPM	50 ns
72-pin SIMM	16 128MB	EDO, FPM	60 ns

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Stacked DRAM and Flash Products

DRAM modules and Flash card products. We offer custom and application-specific stacked DRAM modules including a wide range of DIMMs and SO DIMMs. Our stacked DRAM products are used primarily in high-performance PCs, high-performance servers, workstations, switches and routers, and other custom systems. Our stacked DRAM modules are available in various module form factors and capacities of up to 4GBs. We offer many of these modules utilizing different DRAM architectures such as double data rate (DDR and DDR2), synchronous DRAM (SDRAM), and legacy architectures, such as extended data out (EDO) and fast page mode (FPM). Our stacked Flash products are used primarily in high-end consumer digital applications, such as professional digital cameras and camcorders. We utilize IC Tower stacking technology in our Type II CompactFlash memory cards, enabling us to continuously provide high capacity CompactFlash memory cards.

The following tables describe certain of our stacked DRAM and Flash card products as of March 1, 2005:

Stacked DRAM Product Family	Density		Architecture	Speed (MHz)	
168-pin, 184-pin and 240-pin Registered DIMM	512MB	4GB	DDR, DDR2 SDRAM	66	667
168-pin, 184-pin, and 240 pin DIMM	512MB	4GB	DDR, DDR2, SDRAM	66	667
200-pin Registered DIMM	128MB	2GB	SDRAM	66	133
144-pin and 200-pin SODIMM	128MB	1GB	DDR, DDR2, SDRAM	66	533

Stacked Flash Product Family	Density		Form Factor
CompactFlash	1GB		Type II (36.4mm × 42.8mm × 5.0mm)
Solid-State Drives	8GB	128GB	2.5 inch, 3.5 inch and custom

IC Tower stacked components. Our patented IC Tower stacking technology is a high-density memory packaging technique that uses standard DRAM IC devices to create high-capacity components. We offer a wide selection of stacked components to be used on memory modules and on our customers specific applications. This technology is used in complex, high-capacity module designs and systems. It provides a cost effective solution for our customers by offering chip densities that are less expensive than non-stacked components on a per megabit (Mb) basis.

The following table describes certain of our IC Tower stacking components as of March 1, 2005:

IC Tower Stacked Component Product Family	Component Density		(Architecture) Capacity	Speed (MHz)	
DDR, DDR2	128Mb	1Gb	2 High (32 256MB)	266	667
SDRAM	128Mb	1Gb	2 High (32 256MB)	66	133
EDO/FPM	128Mb		2 High (32MB)	100	133

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Storage Products

External Hard Disk Drives. We offer the SimpleDrive line of storage devices for data storage and back-up. Our SimpleDrive Desktop product line provides high-density, high-speed, cost-effective storage in 120GB to 400GB capacities. Our SimpleDrive Portable product line offers similar features in a smaller, more durable form factor in capacities ranging from 20GB to 80GB. The primary usage of these external hard drives is for easy, plug and play storage expansion and system backup.

Notebook Hard Drive Upgrade kits: We offer hard drive upgrade kits for most major brands of notebook PCs. Our products range in capacity from 20GB to 80GB. The primary use of these products is to enhance the storage capacity of notebook PCs.

Network Attached Storage: SimpleTech announced SimpleShare Office Storage Server in 2004 and commenced production shipments in January 2005. SimpleShare enables users to quickly and easily add up to 250GB of storage capacity to any network. SimpleShare is the easy way to store and share data over any network.

The following table describes certain of our storage products as of March 1, 2005:

Storage Product Family	Density	Connectivity
SimpleDrive Portable	20GB-80GB	USB, USB/FireWire
SimpleDrive Desktop	120GB-400GB	USB, USB/FireWire
Notebook Hard Drive Upgrades	20GB-80GB	IDE
SimpleShare Office Storage Server	160GB and 250GB	Ethernet 10/100 Base T

Research and Development

Our research and development efforts are focused on developing reliable, high-performance and cost-effective memory products to address the needs of traditional and emerging memory applications. We believe the timely development of new products is essential to maintaining our competitive position. Our engineering staff, which consists of 31 persons as of December 31, 2004, works closely with our OEM Division customers and provides services throughout the production cycle, including component selection, schematic design, layout, manufacturing and test engineering expertise. We design our products to be compatible with existing industry standards and, where appropriate, develop and promote new standards. An important aspect of our research and development effort is to understand the challenges presented by our OEM Division customers custom design requirements and satisfy them by utilizing our proprietary technologies and our technical expertise. In the course of meeting our customers challenges, we are often required to develop new technologies and processes, which are later added to our design library. Our design library consists of over 1,000 designs that are available for a wide variety of custom and open-standard product configurations.

We focus primarily on new high-speed memory modules, improvements in manufacturing processes and technologies, and improvements in test routines and related software. We plan to continue to direct our research and development efforts toward the design of new memory products, which address the requirements of our Consumer and OEM Division customers. Our IC Tower stacking technology is a critical component of our research and development effort as it allows us to design solutions that are continually migrating to higher densities for our customers. Our IC Tower stacking technology enables us to produce high-density Flash and DRAM products by manufacturing products in a three-dimensional

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form. These products offer higher-density capacities in the same footprint as the traditional two-dimensional designs. We stack unmodified memory devices to produce higher-density and smaller form factor Flash cards and DRAM modules. We believe this capacity enables us to shorten our customers design cycles for high-density products to lead times normally associated with non-stacked memory solutions. In response to the growth in Flash-based applications, we are focusing on new Flash solutions that provide improved storage capacities, higher-speed read and write capabilities, smaller sizes and new interfaces. Research and development expense was $4,295,000, $2,445,000 and $2,762,000 for the three years ended December 31, 2004, 2003, and 2002, respectively.

Design, Manufacturing and Test

Design and production. The typical production cycle consists of a design stage followed by a prototype stage and ends with full production of the final product. We believe the length of the design stage has been reduced due to rapid improvements in technology. In recent years customers have demanded shorter design and production cycles. In response, we have developed quick-turn design and manufacturing services. By working with our OEM Division customers early in the design and prototype stages, we believe we are able to resolve critical design issues effectively and efficiently, thus shortening the time from prototype design to volume manufacturing. In addition, we believe working closely with our OEM Division customers throughout the design and production stages allows us to gain important insights into their future product requirements. We believe our quick-turn design and manufacturing services also allow us to introduce upgraded products to the consumer market on a timely basis to coincide with new product releases by these customers.

Manufacturing. Our manufacturing processes are highly-automated and involve the use of specialized equipment for the production of memory products. Our manufacturing systems have been optimized to support the placement of a large number of IC devices on each memory board. We believe we are able to achieve a high manufacturing yield and minimize direct labor costs as a result of our design efficiencies, high level of automation and general manufacturing expertise. Because our manufacturing systems can be easily configured for different memory products, we have the ability to offer our customers short manufacturing and test cycles on small and large projects. We also have developed an automated method of manufacturing our IC Tower stacking products which we believe results in further manufacturing efficiencies. Our manufacturing process is ISO 9001 certified.

Test engineering. An important aspect of our manufacturing operations is our focus on test engineering. We test all of our memory products upon completion of manufacturing, which we believe results in low returns due to product defects. We believe our test engineering expertise will continue to grow in importance as the speed and complexity of memory products increase. Our test engineering group develops proprietary processes which, together with our continued investment in advanced testing equipment, have enabled us to consistently produce high-quality products.

Customers

We sell our products through our Consumer and OEM Divisions. We have no long-term sales contracts with our customers. Our Consumer Division sells our products through a variety of distribution channels, including VARS, mail order, distributors, and mass market retailers. Our OEM Division markets our products to OEMs, leveraging our custom design capabilities to offer custom memory solutions to address their specific needs. Our ten largest customers accounted for an aggregate of 68.4% and 51.9% of our total revenues in 2004 and 2003, respectively. Micron Semiconductor, CDW Computer Centers and Smart Modular accounted for 21.3%, 17.9% and 13.7% of our total revenues in 2004 and CDW Computer Centers accounted for an aggregate of 19.2% of our total revenues in 2003. As of December 31, 2004 and 2003, approximately 38.4% and 21.3% of accounts receivable were concentrated with three and two customers, respectively. No other single customer accounted for more than 10.0% of our total revenues or accounts receivable in 2004 or 2003.

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Consumer Division

In 2004, our Consumer Division sold to more than 1,000 customers through VARs, mail order, distributors, and mass market retailers. In addition, through our consumer distribution arrangements, we supply certain of our products to e-commerce companies for their sale of these products on the Internet.

OEM Division

In 2004, our OEM Division sold to more than 200 customers, including sales through OEM distributors and contract manufacturers that incorporate our products into systems they assemble for our OEM Division customers. We define our OEM Division customers as OEMs that have purchased our products directly or ordered our products from OEM distributors and contract manufacturers. Our OEM Division customers make the purchasing decisions on substantially all of the products we sell through OEM distributors and contract manufacturers. For additional information regarding our business segments, see Note 12 to our Consolidated Financial Statements.

We expect that sales of our products to a limited number of customers will continue to represent a majority of our revenues for the foreseeable future and believe that our financial results will depend in significant part upon the success of our customers businesses. We have experienced changes in the composition of our major customer base from quarter to quarter as the market demand for our customers products has changed and we expect this variability to continue in the future. For risks associated with our customer relationships, see Business Risk Factors Sales to a limited number of customers represent a significant portion of our revenues and the loss of any key customer would materially reduce our revenues.

International sales of our products accounted for $50.3 million, or 18.2%, and $39.8 million, or 18.8%, of our total revenues in 2004 and 2003, respectively. In 2003, Europe accounted for $21.9 million, or 10.3%, of our total revenues. No other foreign geographic area or single foreign country accounted for more than 10.0% of our total revenues. Substantially all of our international sales are export sales, which are shipped from our domestic facility to foreign customers. For additional information regarding our international sales, see Note 12 to our Consolidated Financial Statements and Business Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

Sales and Marketing

Consumer Division

We ship SimpleTech brand-name products directly to VARs, mail order, distributors and mass market retailers. In addition to in-house sales representatives, our sales efforts in the consumer channel are supported by manufacturers representatives. For the mail order and mass market retailer channels, we advertise in magazines and newspapers as a way of bringing end-users to our customers locations. We offer certain VARs volume rebates and work with their customers to qualify our products for their information system departments. Volume rebates are used to incentivize certain resellers, rewarding them with a rebate for our products sold. For consumer distributors, we purchase corporate image advertising, offer volume rebates and joint marketing programs, and generate leads at electronics tradeshows and refer those potential customers to our distributors. Through joint marketing programs, we work together with resellers to incorporate the SimpleTech brand in the resellers

existing marketing plans, such as catalogs and web banner ads. In addition, we have developed direct advertising programs with certain of our consumer distributors e-commerce customers in which we market our products on their websites. We also offer account manager incentives, which include sales contests and reward programs designed to sustain reseller loyalty while also creating excitement for increased sales activity.

OEM Division

Our OEM Division uses an internal direct sales force complemented by an external sales force of manufacturers representatives and OEM distributors for sales to OEM Division customers in the United States and internationally. We pursue our customer base on both a geographic and account-specific basis. We believe these combined sales forces have the local presence, market knowledge and strategic insight to allow us to more effectively market our products to a larger number of OEM customers. In addition, as part of our sales and marketing efforts, our experienced applications engineers work closely with our OEM Division customers in designing our products into their systems.

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Customer Service and Support

We provide our customers with comprehensive product service and support. We work closely with our OEM Division customers to monitor the performance of their product designs and to provide application design and support. This also provides us with insight into defining their subsequent generations of products. Our standard OEM Division customer support package is generally offered with all product sales and includes full technical documentation and application design assistance. During our OEM Division customers production phase, we provide extensive support which includes training, system-level design, implementation and integration support. We believe that tailoring our technical support to our OEM Division customers needs is essential to the success of our product introductions and customer satisfaction. Our Consumer Division customers receive technical support on an unlimited, toll-free basis and are assigned a dedicated technician familiar with their account. We also train the account managers of certain Consumer Division customers to keep them informed about changes in our product lines. In addition, we offer Consumer Division customers on-line pricing and navigation tools, and a personalized web page available through our extranet which features personalized information such as promotions, new products and contact information.

Competition

We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our primary competitors in the third-party memory module industry include: Crucial Memory, a division of Micron Technology, Kingston Technology, Lexar Media, M-Systems, PNY Technologies, SanDisk, and SMART Modular. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers.

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

We compete in our target markets based primarily on quality, design and manufacturing technology, price and responsiveness to our customers needs. We expect our competitors will continue to improve the performance of their current products, reduce their current product sales prices and introduce new products that may offer greater performance and improved pricing, any of which could cause a decline in sales or loss of market acceptance of our products.

To remain competitive, we must, among other things:

Provide best-of-class design, manufacturing and test engineering services;

Maintain quality levels;

Provide technologically advanced products;

Successfully protect our intellectual property rights;

Accurately anticipate and prepare for new technological trends and standards in the industry;

Compete favorably on the basis of price and sales and marketing incentives;

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Offer flexible delivery schedules; and

Deliver finished products on a timely basis in sufficient volume to satisfy our customers requirements.

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

Suppliers

IC devices represent more than 90% of the component costs of our manufactured Flash cards and DRAM modules. We purchase these IC devices from a small number of suppliers. In 2004, our significant suppliers of IC devices included:

Flash IC Device Suppliers	DRAM IC Device Suppliers
Matsushita	Infineon Technologies
Renesas	Micron Technology
Samsung	Samsung

We are dependent on a small number of suppliers to supply Flash IC and DRAM IC devices. We have no long-term DRAM or Flash IC device supply contracts. We periodically review opportunities to develop alternative sources for our Flash IC and DRAM IC device needs. However, our options are very limited because of the small number of memory manufacturers. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. Samsung, Renesas, and Matsushita supply substantially all of the IC devices used in our Flash memory products. In addition, Samsung, Micron Technology and Infineon Technologies currently supply a majority of the DRAM IC devices used in our DRAM memory products. For risks associated with our supplier relationships, see Business Risk Factors Our dependence on a small number of suppliers for integrated circuit, or IC, devices and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.

Seasonality

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

Backlog

Sales of our memory products are made under short-term cancelable orders. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming six months. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues. In addition, there can be no assurance that current backlog will necessarily lead to revenues in any future period. Our combined backlog was $8.1 million as of December 31, 2004 and $12.5 million as of December 31, 2003. Our Consumer Division backlog was $2.1 million as of December 31, 2004 and $5.0 million as of December 31, 2003. Our OEM Division backlog was $6.0 million as of December 31, 2004 and $7.5 million as of December 31, 2003. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

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Intellectual Property Rights

We regard our patents, trademarks, trade secrets and other intellectual property as critical to our success. We rely on patents, trademarks, copyrights and trade secret laws, confidentiality procedures, and employee disclosure and invention assignment agreements to protect our intellectual property rights.

As of March 1, 2005, we owned 14 U.S. patents, including U.S. Patents No. Re. 36,916 and No. 6,762,487 related to our stacking products, and 10 additional patent applications were pending. We have agreements to license certain of our intellectual property to third parties. In addition, we have entered into several licensing agreements to license the intellectual property of others. License fees related to the license of our intellectual property and our license of third party intellectual property were nominal for all periods presented in this report. Although we consider the patents currently held by us to be critical to our success, there can be no assurance that any patents currently held by us or any patents which may be granted to us in the future will not be challenged, invalidated or circumvented, or that rights granted thereunder will provide meaningful protection or other commercial advantage to us. There can be no assurance that third parties will not develop similar products, duplicate our products or design around the patents currently owned by us or which may be granted to us in the future. Because we view intellectual property rights as critical to our success, we intend to pursue future patents and other intellectual property rights in the U.S. There can be no assurance that we will be successful in these endeavors. In addition there can be no assurance that our trade secrets and know-how may not become known to third parties, or become part of the public domain, which in either case would harm our financial performance and business operations.

We have on at least one occasion applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in some foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. In addition, from time to time, third parties may bring suits against us. For details regarding our pending intellectual property lawsuits, see Legal Proceedings and Business Risk Factors We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.

In the event of an adverse result in any such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use infringed technology. Any litigation, whether as plaintiff or as defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In addition, the results of any litigation are inherently uncertain.

In the event we desire to incorporate third-party technology into our products or our products are found to infringe on others patents or intellectual property rights, we may be required to license such patents or intellectual property rights. If we obtain licenses from third parties, we may be required to pay license fees or make royalty payments, which could reduce our gross margins. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. In addition, any development or license negotiations could require substantial expenditures of time and other resources by us.

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless certain of our suppliers and customers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights.

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The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. We may from time to time be engaged in litigation as a result of such indemnification obligations. In addition, our insurance does not cover intellectual property infringement.

In our efforts to maintain the confidentiality and ownership of trade secrets and other confidential information, all of our employees are required to sign employee non-disclosure and invention assignment agreements. This agreement requires our employees to disclose, document and assign their interest in all inventions, patents and copyrights developed while employed with us. Our employees further agree to preserve all of our confidential information including trade secrets, customer information, know-how and other business information. There can be no assurance that these agreements will provide meaningful protection of our trade secrets or other confidential information in the event of unauthorized use or disclosure of such information. See Business Risk Factors Our intellectual property may not be adequately protected, which could harm our competitive position.

Employees

As of December 31, 2004, we had 389 full-time employees, consisting of 202 in manufacturing (including test, quality assurance and material management), 106 in sales and marketing, 50 in finance and administration and 31 in design and product development. Our employees are not represented by any collective bargaining agreements and we have never experienced a work stoppage. Management believes that relations with our employees are good.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. Before purchasing our common stock, you should carefully consider the risks described below in addition to the other information in this Report. Our business, results of operations and financial condition may be materially and adversely affected due to any of the following risks. The risks described below are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The trading price of our common stock could decline due to any of these risks, and you could lose all or part of your investment. In assessing these risks, you should also refer to the other information contained or incorporated by reference in this Report, including our consolidated financial statements and related notes.

This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

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

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

- Our suppliers production levels for the components used in our products;
- Our ability to procure required components or fluctuations in the cost of such components;
- Fluctuating market demand for, and changes in the average sales prices of our products;
- Changes in our product and revenue mix;
- Seasonal purchasing patterns for our products with lower sales generally occurring in the first and second quarters followed by higher sales in the fourth quarter of each year;
- Market acceptance of new and enhanced versions of our products;
- The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;
- Order cancellations, product returns, inventory write-downs, price protections, and rebates;

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

Expenses associated with acquisitions;

Our ability to adequately support future rapid growth;

Our ability to absorb manufacturing overhead;

The effects of litigation;

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

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

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

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

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

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

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

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

In addition, the continued transition to smaller design geometries and the use of 300 millimeter wafers by existing memory manufacturers could lead to a significant increase in the worldwide supply of DRAM and Flash components. Increases in the worldwide supply of DRAM and Flash

components could also result from manufacturing capacity expansions. If not offset by increases in demand, these increases would likely lead to further declines in the average sales prices of our products and have a material adverse effect on our business and operating results. Furthermore, even if supply remains constant, if demand were to decrease, it would harm our average sales prices.

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

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices. From 2001 through the first quarter of 2003, a downturn in the semiconductor industry negatively impacted our average sales prices, revenues and earnings. These conditions began to improve during the second quarter of 2003 and have continued to improve through the end of 2004 as demand for DRAM products increased and component prices stabilized. However, there can be no assurance that the demand for DRAM products will increase or component prices will remain stable or that such trends will continue in the future. Any future downturns could have a material adverse effect on our business and results of operations.

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

Our dependence on a limited number of customers means that the loss of a major customer or any reduction in orders by a major customer would materially reduce our revenues. Historically, a relatively limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 68.4% of our total revenues in 2004 and 51.9% of our total revenues in 2003. Our ten largest Consumer Division customers accounted for an aggregate of 66.1% of our Consumer Division revenues, or 34.5% of our total revenues, in 2004 and 58.4% of our Consumer Division revenues, or 42.3% of our total revenues, in 2003. Our largest Consumer Division customer in 2004 and 2003, CDW Computer Centers, accounted for 34.2% of our Consumer Division revenues, or 17.9% of our total revenues, for 2004 and 26.6% of our Consumer Division revenues, or 19.2% of our total revenues, in 2003. No other Consumer Division customer accounted for more than 10.0% of our total revenues in 2004 or 2003.

Our ten largest OEM Division customers accounted for an aggregate of 85.9% of our OEM Division revenues, or 41.1% of our total revenues, in 2004 and 72.2% of our OEM Division revenues, or 19.9% of our total revenues, in 2003. Our largest OEM Division customers in 2004, Micron Semiconductor and Smart Modular, accounted for 44.6% and 29.8%, respectively, of our OEM Division revenues, or 21.3% and 13.7%, respectively, of our total revenues, for 2004. No other single OEM Division customer accounted for more than 10.0% of our total revenues in 2004 or 2003.

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

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

In recent years, we generated net operating losses and tax credits, which we have not been able to fully utilize at this time. The availability of some of these net operating losses and tax credit carryforwards are subject to expiration and/or certain limitations. As of December 31, 2004, we had federal net operating loss carryforwards of approximately $1.1 million, which begin to expire in 2023, and state net operating loss carryforwards of approximately $100,000, which begin to expire in 2013. As of December 31, 2004, we

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had federal research and development credit carryforwards of approximately $1.5 million, which begin to expire in 2022. In addition, we had the following state credits as of December 31, 2004: research and development credit carryforwards of approximately $1.8 million, which carryforward indefinitely; enterprise zone credit carryforwards of approximately $1.9 million, which carryforward indefinitely; and manufacturer s investment credit carryforwards of approximately $498,000, which begin to expire in 2009. We are required to periodically review our ability to use our net operating loss and tax credit carryforwards. Such review may result in the limiting of the amount of net operating losses or tax credit carryforwards that can be utilized in the future to offset future taxable income or tax liabilities. Since the limitation is based on a number of factors, we cannot determine the impact of such a limitation at this time but, if our ability to use net operating loss and tax credit carryforwards were substantially limited, it could harm our financial condition.

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

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

In addition, there has been an ongoing public debate as to whether employee stock option and employee stock purchase plan shares should be treated as a compensation expense and, if so, how to properly value such charges. We have accounted for employee stock options and employee stock purchase plan shares for financial and accounting purposes under APB Opinion No. 25, which does not count the grant of stock or options as an expense. In December 2004, the Financial Accounting Standards Board published amendments to financial accounting standards that will require that awards under such plans be treated as compensation expense using the fair value method. Although management is continuing to assess the implications of this revised standard, we believe this revised standard will likely significantly increase our compensation expense, could make our operating results less predictable and could change the way we compensate our employees or cause other changes in the way we conduct our business. For discussion of our employee stock option plan, see Note 10 Stock Option Plan .

Failure to maintain effective internal controls over financial reporting could adversely affect our business and the market price of our common stock.

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

Our filing of our annual report on a timely basis will depend upon our timely completion of these tasks and our independent public accounting firm s timely completion of the review of our internal control systems. Our independent public accounting firm is responsible for auditing and reviewing managements reports of many other companies, and our deadlines could be difficult for them to meet. A late annual report could have material adverse effects on us, both legally and with respect to the opinions of the participants in the securities market.

If we identify one or more material irremediable weaknesses in our internal controls over financial reporting, our management will be unable to assert such internal controls are effective. If we are unable to assert that our internal controls over financial reporting are effective, or if our auditors are unable to attest that our management s report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls, we could lose investor confidence in the accuracy and completeness of our financial reports, which would have an adverse effect on our business and the market price of our common stock.

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

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

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

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

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

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

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

Problems assimilating the purchased operations, technologies or products;

Costs associated with the acquisition;

Adverse effects on existing business relationships with suppliers and customers;

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

Potential loss of key employees of purchased organizations; and

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

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

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

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

Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer and director of SimpleTech, are brothers and beneficially own approximately 57.9% of our outstanding common stock at December 31, 2004. In addition, they have a non-binding understanding that at any shareholders meeting of SimpleTech where action is to be taken with respect to the election of directors, they each would cause the shares of SimpleTech common stock beneficially owned by them to be voted in favor of their election as directors. As a result, they have the ability to control all matters requiring approval by our shareholders, including the election and removal of directors, approval of significant corporate transactions and the decision of whether a change in control will occur. This control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

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

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

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

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

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

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

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

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

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

- Prevent the challenge, invalidation or circumvention of our existing patents;
- Result in patents that lead to commercially viable products or provide competitive advantages for our products;
- Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;
- Prevent third-party patents from having an adverse effect on our ability to do business;

Provide adequate protection for our intellectual property rights;

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

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

Result in patents from any of our pending applications.

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

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

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

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

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

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

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

The memory, high-performance computing, networking and communications, consumer electronics and OEM markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop,

introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

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

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

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

The Flash-based storage market is constantly undergoing rapid technological change and evolving industry standards. Many consumer devices, such as digital cameras, PDAs and smartphones, may transition to emerging Flash memory formats, such as the xD Picture Card format, which we do not currently manufacture and do not have rights to manufacture. This will likely result in a decline in demand, on a relative basis, for other products that we manufacture such as CompactFlash, Secure Digital and MultiMedia cards. If we decide to manufacture Flash products utilizing emerging formats, such as the xD Picture Card, we will be required to secure licensing arrangements to give us the right to manufacture such products which may not be available at reasonable rates or at all. If we are not able to supply all Flash card formats at competitive prices or if we were to have product shortages, our revenues could be adversely impacted and our customers would likely cancel orders or seek other suppliers to replace us.

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

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

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

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products with our customers, we may incur increased and unexpected costs associated with this inventory. For example, if our Consumer Division customers are unable to sell their inventory in a timely manner, we may choose or be required to lower the price of our products or allow our customers to exchange the slow-moving products for newer products. Similarly, if we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. As a result, we could incur increased expenses associated with writing off excess or obsolete inventory. A majority of our sales through commercial channels include limited rights to return

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unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. In addition, some of our inventory is sold on a consignment basis, and we have very little ability to control or manage that inventory. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error.

We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were $1.1 million in 2004, compared to $367,000 in 2003. Inventory write-downs increased in 2004 due primarily to greater DRAM and Flash component price volatility compared to 2003. In addition, we offer some of our Consumer Division customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of $854,000 in 2004, compared to $1.3 million in 2003. We also offer rebate programs through some of our Consumer Division customers to end-users. We incurred rebate charges of $298,000 in 2004, compared to $1.4 million in 2003. Price protection and rebate charges declined in 2004 compared to 2003 due primarily to a reduction of the number of customers that we offer price protection and rebate programs to as a result of our decision to reduce the sales of our Flash products into certain unprofitable sales channels.

We are also subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, we may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of December 31, 2004, we have never been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that we will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were relatively flat at $1.1 million in 2004, compared to $1.2 million in 2003.

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

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

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

- foreign laws and regulations, which may vary country by country, may impact how we conduct our business;
- higher costs of doing business in certain foreign countries, including different employment laws;
- difficulty protecting our intellectual property rights from misappropriation or infringement;

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

political or economic instability;

changes in import/export duties;

necessity of obtaining government approvals;

trade restrictions;

work stoppages or other changes in labor conditions;

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

taxes;

longer payment cycles and foreign currency fluctuations; and

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

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

We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

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

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales of our products accounted for 18.2% and 18.8% of our revenues in 2004 and 2003, respectively. Except for Europe, which accounted for 10.3% of our revenues in 2003, no other foreign geographic area or single foreign country

accounted for more than 10.0% of our revenues in 2004 or 2003. For 2004 and 2003, more than 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country s currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

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

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

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

Although we have been profitable for most of our history, we have experienced losses on a quarterly and annual basis in the past. In 2003 and in the second quarter of 2004, we incurred net losses of $1.6 million and $1.9 million, respectively. We have expended, and will continue to expend, substantial funds to pursue engineering, research and development projects, enhance sales and marketing efforts and otherwise operate our business. There can be no assurance that we will be profitable on a quarterly or annual basis in the future.

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

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

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

We are subject to a variety of environmental laws and regulations governing, among other things, air emissions, waste water discharge, waste storage, treatment and disposal, and remediation of releases of hazardous materials. Our failure to comply with present and future requirements could harm our ability to continue manufacturing our products. Such requirements could require us to acquire costly equipment or to incur other significant expenses to comply with environmental regulations. The imposition of additional or more stringent environmental requirements, the results of future testing at our facilities, or a determination that we are potentially responsible for remediation at other sites where problems are not presently known to us, could result in expenses in excess of amounts currently estimated to be required for such matters.

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

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

Act and other regulations related to working conditions, wage-hour pay, over-time pay, employee benefits, anti-discrimination, and termination of employment.

Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. In addition from time to time we have received, and expect to continue to receive,

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correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances the former employee has brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys fees and costs.

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

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

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

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

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

These provisions include:

- limitations on who may call special meetings of shareholders;
- advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;
- elimination of cumulative voting in the election of directors;
- the right of a majority of directors in office to fill vacancies on the board of directors;

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

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

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ITEM 2. PROPERTIES

We occupy two leased facilities of approximately 24,500 and 48,600 square feet in Santa Ana, California, in which our executive offices, manufacturing, engineering, research and development and testing operations are located. We lease the 24,500 square foot facility from MDC Land LLC, a limited liability company owned by Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer, director and major shareholder of SimpleTech, for a base rent of $17,000 per month. This lease expires in July 2017. For the period beginning August 1, 2005 through July 31, 2007, this lease provides that the base rent shall be the greater of $17,000 per month or the market value rent as determined by an independent appraiser. Thereafter, for the remainder of the lease, base rent shall be adjusted every two years based on the change in the Consumer Price Index.

We also lease the 48,600 square foot facility from MDC Land LLC for a base rent of $33,000 per month. This lease also expires in July 2017. For the period beginning August 1, 2005 through July 31, 2007, this lease provides that the base rent shall be the greater of $33,000 per month or the market value rent as determined by an independent appraiser. Thereafter, for the remainder of the lease, base rent shall be adjusted every two years based on the change in the Consumer Price Index. We also lease various small facilities for our sales offices and storage. We believe that our existing leased space is adequate for our current operations and that suitable replacement and additional spaces will be available in the future on commercially reasonable terms.

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ITEM 3. LEGAL PROCEEDINGS

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

We received notice on November 26, 2001, that the Lemelson Medical, Education & Research Foundation, LLP filed a complaint on November 13, 2001, against us and other defendants. The complaint was filed in the District Court of Arizona and alleges that our manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, we were served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative, and we have not made any such estimate at this time.

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

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

None.

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PART II.

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on The Nasdaq National Market under the symbol STEC. Our initial public offering of stock occurred on September 29, 2000. Prior to that time, there was no public market for our common stock. The following table sets forth the range of high and low intra-day sales prices reported on The Nasdaq National Market for our common stock for the periods indicated.

	Price range of Common Stock	
	High	Low
Year Ended December 31, 2004:		
First Quarter	$ 6.99	$ 4.22
Second Quarter	$ 5.90	$ 3.22
Third Quarter	$ 4.18	$ 2.76
Fourth Quarter	$ 5.51	$ 3.56
Year Ended December 31, 2003:		
First Quarter	$ 3.51	$ 1.97
Second Quarter	$ 4.36	$ 2.20
Third Quarter	$ 8.45	$ 3.50
Fourth Quarter	$ 11.04	$ 4.87

Recent Share Prices

The following table sets forth the closing sales prices per share of our common stock on The Nasdaq National Market on December 31, 2004 and March 1, 2005. Because the market price of our common stock is subject to fluctuation, the market value of the shares of our common stock may increase or decrease.

	Closing Price
December 31, 2004	$ 4.60
March 1, 2005	$ 4.02

Holders

As of March 1, 2005, there were 55 holders of record of our common stock.

Dividend Policy

We were originally incorporated as an S corporation in March 1990 and converted to a C corporation in September 2000. Since becoming a C corporation, we have not declared or paid any cash dividends on our common stock and do not expect to do so in the foreseeable future. We currently intend to retain all available funds for use in the operation and expansion of our business. Any future determination to pay dividends will be at the discretion of our board of directors and will depend principally upon our results of operations, financial conditions, capital requirements, contractual and legal restrictions and other factors the board deems relevant.

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Recent Sales of Unregistered Securities

None

Use of Proceeds from Sales of Registered Securities

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

Equity Compensation Plan Information

The equity compensation plan information required by this Item is set forth in Part III, Item 12 of this Annual Report on Form 10-K.

Issuer Purchases of Equity Securities

The number of shares of our common stock repurchased and the average price paid per share for each month in the three months ended December 31, 2004 are as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares as Part of Publicly Announced Program (1)	Maximum Dollar Value that May Yet be Purchased Under the Program
October 1 through October 31	0		749,309	$ 12,332,460
November 1 through November 30	92,200	$ 4.67	841,509	$ 11,901,431
December 1 through December 31	0		841,509	$ 11,901,431
Total	92,200	$ 4.67	841,509	$ 11,901,431

(1) On June 16, 2004 we announced that our board of directors had authorized a share repurchase program enabling us to repurchase up to $15 million of our common stock over an 18-month period expiring on December 16, 2005. The shares may be purchased from time to time at prevailing market prices through open market or unsolicited negotiated transactions, depending on market conditions and other considerations. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue purchases at

any time that management determines that additional purchases are not warranted. Repurchased shares would be returned to the status of authorized but unissued shares of common stock. All shares were purchased pursuant to our existing share repurchase program. As of March 1, 2005, we had repurchased 2,397,878 shares of our common stock at an average price of $3.82 per share for an aggregate purchase price of $9,153,925 since inception of our existing share repurchase program and the remaining authorized amount for stock repurchases under this program was $5,846,075.

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ITEM 6. SELECTED FINANCIAL DATA

You should read the following selected consolidated financial data in conjunction with our consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this Report. The consolidated statement of operations data for each of the three years in the period ended December 31, 2004 and the consolidated balance sheet data at December 31, 2003 and 2004 were derived from our consolidated financial statements that have been audited by our independent registered public accounting firm, and are included elsewhere in this Report. The consolidated statement of operations data for the years ended December 31, 2000 and 2001 and the consolidated balance sheet data at December 31, 2000, 2001 and 2002 were derived from our audited consolidated financial statements and are not included in this Report.

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(in thousands)	Year Ended December 31, 2004	2003	2002	2001	2000
Consolidated Statement of Operations Data:					
Net revenues	$ 275,432	$ 211,806	$ 176,531	$ 164,241	$ 308,316
Cost of revenues	228,269	175,927	143,582	127,832	239,964
Gross profit	47,163	35,879	32,949	36,409	68,352
Sales and marketing	19,875	18,787	17,527	18,078	21,588
General and administrative	10,106	10,077	10,328	11,262	11,853
Research and development	4,295	2,445	2,762	4,297	3,745
Non-recurring legal settlement					1,810
Total operating expenses	34,276	31,309	30,617	33,637	38,996
Operating income (loss)	12,887	4,570	2,332	2,772	29,356
Interest income (expense), net	1,052	557	778	1,395	(1,158)
Income (loss) from continuing operations before provision (benefit) for income taxes	13,939	5,127	3,110	4,167	28,198
Provision (benefit) for income taxes	5,158	1,645	(188)	1,655	2,838
Income (loss) from continuing operations	$ 8,781	$ 3,482	$ 3,298	$ 2,512	$ 25,360
Loss from discontinued operations before benefit for income taxes	(7,115)	$ (8,728)	$ (8,196)		
Benefit for income taxes	(3,023)	$ (3,598)	$ (3,507)		
Loss from discontinued operations	$ (4,092)	$ (5,130)	$ (4,689)		
Net income (loss)	$ 4,689	$ (1,648)	$ (1,391)		
Pro Forma Data (1):					
Income before provision for income taxes					$ 28,198
Pro forma provision for income taxes					10,883
Pro forma net income					$ 17,315
Net income (loss) per share (pro forma in 2000) (2):					
Basic:					
Continuing operations	$ 0.18	$ 0.09	$ 0.08	$ 0.07	$ 0.53
Discontinued operations	$ (0.08)	$ (0.13)	$ (0.12)		
Total	$ 0.10	$ (0.04)	$ (0.04)	$ 0.07	$ 0.53
Diluted:					
Continuing operations	$ 0.17	$ 0.08	$ 0.08	$ 0.06	$ 0.50
Discontinued operations	$ (0.08)	$ (0.12)	$ (0.11)		
Total	$ 0.09	$ (0.04)	$ (0.03)	$ 0.06	$ 0.50

Shares used in computation of net income (loss) per share:					
Basic	47,707,365	40,408,610	38,515,825	38,126,687	32,393,218
Diluted	49,563,208	42,559,586	40,336,008	39,435,505	34,593,678

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	December 31,				
	2004	2003	2002	2001	2000
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 73,346	$ 30,769	$ 24,442	$ 51,831	$ 33,747
Marketable securities	9,972	45,625	19,530		
Working capital	121,564	114,112	60,681	64,733	64,300
Total assets	153,409	153,669	94,240	89,114	103,286
Long-term portion of debt and capital lease obligations				384	1,642
Total shareholders equity	131,428	128,324	73,902	74,045	69,913

(1) From our formation in March 1990 to September 26, 2000, we elected for federal and state income tax purposes to be treated as an S corporation under Subchapter S of the Internal Revenue Code of 1986 and comparable state tax laws and filed our federal and state income tax returns on that basis. Accordingly, no provision has been made for federal or certain state income taxes. Pro forma net (loss) income has been computed using an effective tax rate of 38% to reflect the estimated income tax (benefit) expense as if we had been fully subject to federal and state income taxes as a C corporation for all periods presented. Subsequent to the termination of our S corporation status on September 26, 2000, we have paid federal and state corporate-level income taxes as a C corporation.

(2) Reflects a 5.07 for 1 stock split of our common stock in September 2000. All share and per share amounts have been adjusted to give retroactive effect to the stock split.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to such consolidated financial statements included elsewhere in this Report beginning on page F-1. The following discussion contains forward-looking statements that involve risks and uncertainties. Investors should not place undue reliance on these forward-looking statements. These forward-looking statements are based on current expectations and actual results could differ materially from those discussed herein. Factors that could cause or contribute to the differences are discussed in Business Risk Factors and elsewhere in this Report. Our actual results could differ materially from those predicted in these forward-looking statements, and the events anticipated in the forward-looking statements may not actually occur. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We are under no duty to update any of the forward-looking statements after the date of this Report to conform these statements to actual results or to reflect the occurrence of unanticipated events, unless required by law.

Overview

SimpleTech, Inc. was originally incorporated in California in March 1990 as Simple Technology, Inc. Our name was then changed to SimpleTech, Inc. in May 2001. SimpleTech designs, manufactures and markets custom and open-standard memory solutions based on Flash and DRAM memory technologies. Headquartered in Santa Ana, California, SimpleTech offers a comprehensive line of over 2,500 products and specializes in developing high-density memory modules, memory cards and storage drives.

In June 2004, we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC. We expect that several of the initiatives we implemented in 2004, such as discontinuing the operations of our Xiran Division and reducing our general and administrative costs, including legal and litigation costs, will result in a decrease in operating expenses of nearly $10 million per year. Our consolidated financial statements have been reclassified to reflect the Xiran Division as a discontinued operation for all prior periods presented.

After we experienced revenue growth of 57.5% from 1998 to 1999 and 60.1% from 1999 to 2000, revenues declined 46.7% in 2001 and then increased 7.5% in 2002, 20.0% in 2003 and 30.0% in 2004. Annual revenues in 2001 and 2002 were negatively impacted by deteriorating macroeconomic conditions, severe declines in the price of DRAM components, and significantly reduced sales to customers in the communications and networking markets. These negative conditions began to improve in the second quarter of 2003 and have continued to improve through the end of 2004 as demand for DRAM products increased and component prices stabilized. However, there can be no assurance that Flash and DRAM demand or component prices will increase or remain stable or that such trends will continue in the future. We have targeted five areas for potential revenue growth in 2005: Flash-based products for military applications, reduced-sized Flash cards for mobile handsets, expansion of our international business, stacking products for new server and telecom customers and external NAS storage devices in retail stores and for OEMs.

Over the past several years, we have experienced an increase in demand for our Flash products as a result of the growth in consumer electronics and OEM applications, such as the replacement of rotating disk drives with Flash products. Our Flash revenues increased from $24.9 million for the year ended December 31, 1999 to $54.7 million for the year ended December 31, 2002 to $80.3 million for the year ended December 31, 2003. Despite this growth, our revenues from Flash products in 2004 dropped to $62.2 million due to the negative impact of Flash supply constraints and competitive component pricing issues. We believe the expected addition of new Flash suppliers in the industry and increased industry Flash capacity in 2005, as well as the launch in late 2004 of our new Flash products targeted at military and mobile handset applications, will have a positive impact on our Flash revenues and gross margins as well as our competitiveness in the market. We had no revenue from these new Flash products in 2004.

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In addition, we have experienced significant growth over the past year in demand for our IC Tower stacking DRAM products from customers in the networking and server market sectors. Our high-capacity IC Tower stacking DRAM modules are used by our customers in their high-end switching equipment and enterprise servers where maximizing memory content in the device is a priority. Our IC Tower stacking DRAM revenues have grown from $34.2 million for the year ended December 31, 2003 to $104.9 million for the year ended December 31, 2004.

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

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

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 68.4% of our total revenues in 2004, 51.9% of our total revenues in 2003 and 55.5% of our total revenues in 2002. Micron Semiconductor, CDW Computer Centers and Smart Modular accounted for 21.3%, 17.9% and 13.7%, respectively, of our total revenues in 2004. CDW Computer Centers accounted for 19.2% of our total revenues in 2003 and 21.1% of our total revenues in 2002. Other than Micron Semiconductor, CDW Computer Centers and Smart Modular, no other customer accounted for more than 10.0% of our total revenues in 2004, 2003 and 2002. The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, would harm our business, financial condition and results of operations. See Business Risk Factors Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues. For further details on our major customers, see Business Customers.

International sales of our products constituted 18.2% of our total revenues in 2004, 18.8% of our total revenues in 2003 and 14.8% of our total revenues in 2002. Except for Europe, which accounted for 10.3% of our revenues in 2003, no other foreign geographical area or single foreign country accounted for more than 10.0% of our revenues in 2004, 2003 and 2002. Over 95.0% of our international sales were denominated in U.S. dollars in 2004, 2003 and 2002. In addition, our purchases of IC components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See Business Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

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

Results of Operations

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues. In June 2004, we discontinued the operation of our Xiran Division. The table below does not include the revenues and operating expenses of our

Xiran division, which is presented as discontinued operations.

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	2004	2003	2002
Net revenues	100.0%	100.0%	100.0%
Cost of revenues	82.9	83.1	81.3
Gross profit	17.1	16.9	18.7
Operating expenses			
Sales and marketing	7.2	8.9	9.9
General and administrative	3.7	4.8	5.9
Research and development	1.5	1.1	1.6
Total operating expenses	12.4	14.8	17.4
Operating income	4.7	2.1	1.3
Interest income	0.4	0.3	0.4
Income before provision for income taxes	5.1	2.4	1.7

Comparison of the years ended December 31, 2004 and 2003

Net Revenues. Our revenues increased 30.0% from $211.8 million in 2003 to $275.4 million in 2004. Sales of memory products accounted for 94.3% of our revenues in 2004, compared to 93.3% of our revenues in 2003. The increase in revenues from 2003 to 2004 was due primarily to a 49% increase in our average sales price from $53 in 2003 to $79 in 2004, partially offset by a 13% decrease in units shipped from 4.0 million units in 2003 to 3.5 million units in 2004. The decrease in unit volume resulted from unit volume decreases of 20% for Flash products and 19% for standard memory products, partially offset by a unit volume increase of 51% for IC Tower stacking products and 22% for non-DRAM, non-Flash products such as SRAM, hard drive upgrade kits and connectivity products. The increase in IC Tower stacking units shipped resulted primarily from an increase in sales of IC Tower stacking products to OEM customers in the server and telecom markets. The decrease in Flash product units shipped resulted primarily from Flash supply constraints and negative competitive component pricing issues that we encountered in most of 2004. The increase in our average sales price resulted primarily from a mix shift toward higher average sales price IC Tower stacking products and more stable DRAM component prices in 2004 compared to 2003. The mix of products sold varies from quarter to quarter and may vary in the future, affecting our overall average sales price and gross margin.

Our OEM Division revenues increased 125.5% from $58.4 million in 2003 to $131.7 million in 2004. The increase in OEM Division revenue was due to a 113% increase in average sale price from $67 in 2003 to $143 in 2004, and a 6% increase in OEM Division unit volume. Our OEM Division revenue growth was driven primarily by a significant increase in sales of our higher average selling price IC Tower stacking products. Consumer Division revenues decreased 6.3% from $153.4 million in 2003 to $143.7 million in 2004. The decrease in Consumer Division revenue was due to a 18% decrease in unit volume, partially offset by a 14% increase in average sale price from $49 in 2003 to $56 in 2004. The decrease in unit volume was due primarily to a decrease in the sale of Flash products through the retail channel.

Our combined backlog was $8.1 million as of December 31, 2004, compared to $12.5 million as of December 31, 2003. Our OEM Division backlog was $6.0 million as of December 31, 2004, compared to $7.5 million as of December 31, 2003. Our Consumer Division backlog was $2.1 million as of December 31, 2004, compared to $5.0 million as of December 31, 2003. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues.

Gross Profit. Our gross profit increased 31.5% from $35.9 million in 2003 to $47.2 million in 2004. Gross profit as a percentage of revenues increased nominally from 16.9% in 2003 to 17.1% in 2004. Gross profit as a percentage of revenues for our OEM Division decreased from 22.0% in 2003 to 19.4% in 2004 as a

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result of a significant shift in product mix toward lower-margin IC Tower stacking products, which also resulted in a 113.4% increase in OEM Division average sales price from 2003 to 2004. Gross profit as a percentage of revenues for our Consumer Division was flat at 15.0% in 2004 and 2003. As a result of our OEM Division selling a larger percentage of higher margin, higher capacity DRAM, Flash memory and IC Tower stacking products, gross profit as a percentage of revenues for our OEM Division is typically higher than our Consumer Division.

Sales and Marketing. Sales and marketing expenses are comprised primarily of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses increased from $18.8 million in 2003 to $19.9 million in 2004. Sales and marketing costs increased due primarily to an increase in variable sales and marketing costs that resulted from a larger revenue base. Sales and marketing expenses as a percentage of revenues decreased from 8.9% in 2003 to 7.2% in 2004. Sales and marketing expenses as a percentage of revenues decreased due primarily to leveraging certain fixed sales and marketing costs against a larger revenue base.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $10.1 million in 2004 and 2003. General and administrative expenses as a percentage of revenues decreased from 4.8% in 2003 to 3.7% in 2004 primarily due to leveraging certain fixed general and administrative costs against a larger revenue base.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses increased 79.2% from $2.4 million in 2003 to $4.3 million in 2004. Research and development expenses as a percentage of revenues increased from 1.1% in 2003 to 1.5% in 2004. Research and development expenses increased year-over-year from 2003 to 2004 due primarily to our investment in the development of our Flash-based Zeus product line for military applications and our NAS external storage drive product line. These product lines, which were launched in late 2004, are expected to contribute to revenue in the first half of 2005.

Interest Income. Interest income is comprised primarily of interest income from our cash, cash equivalents and marketable securities. Interest income was $557,000 in 2003 compared to $1.1 million in 2004. Interest income increased from 2003 to 2004 due primarily to a higher average balance of cash, cash equivalents and marketable securities and higher interest rates. The higher average balance of cash, cash equivalents and marketable securities was impacted by the proceeds from our offering of common stock in October 2003.

Provision for income taxes. Provision for income taxes from continuing operations was $1.6 million in 2003 and $5.2 million in 2004. Provision for income taxes as a percentage of income before provision for income taxes was 32.0% in 2003 compared to 37.0% in 2004. The increase in the effective rate in 2004 resulted from the decrease in research and development, state enterprise zone, and manufacturer s investment tax credits available in 2004 compared to 2003.

Income from continuing operations. Income from continuing operations was $3.5 million in 2003 and $8.8 million in 2004.

Discontinued Operations. In June 2004, we discontinued the operation of our Xiran Division. No revenues or operating expenses were recorded in the second half of 2004 related to our discontinued Xiran Division. The operating expense figures above do not include operating expenses related to our discontinued Xiran Division during the first half of 2004 and full year 2003.

Comparison of the years ended December 31, 2003 and 2002

Net Revenues. Our revenues were $211.8 million in 2003, compared to $176.5 million in 2002. Revenues increased 20.0% in 2003 due primarily to a 12% increase in units shipped and a 6% increase in average

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sales price from $50 in 2002 to $53 in 2003. The increase in our average sales price resulted primarily from an increase in the percentage of revenues derived from our OEM Division, which typically sells higher-capacity products with a higher average sales price. Unit shipments growth was comprised of unit volume increases of 149% for IC Tower stacking products and 36% for Flash products, partially offset by decreases of 48% for non-DRAM, non-Flash products and 6% for non-stacked DRAM memory products.

Our OEM Division revenues increased 41.0% from $41.5 million in 2002 to $58.4 million in 2003. The increase was due primarily to a 31% increase in OEM Division average sales price from $51 in 2002 to $67 in 2003, and a 7% increase in OEM Division unit volume. The increase in OEM Division average sales price resulted primarily from an increase in the percentage of OEM Division revenues derived from our IC Tower stacking products, which are typically higher-capacity products with a higher average sales price. Our Consumer Division revenues increased 13.6% from $135.0 million in 2002 to $153.4 million in 2003. Consumer Division revenues increased in 2003 due primarily to a 14% increase in Consumer Division unit volume. Consumer Division average sales price was flat at $49 in 2003 and 2002.

Our combined backlog was $12.5 million as of December 31, 2003, compared to $5.8 million as of December 31, 2002. Our OEM Division backlog was $7.5 million as of December 31, 2003, compared to $4.3 million as of December 31, 2002. Our Consumer Division backlog increased from $1.5 million as of December 31, 2002, to $5.0 million as of December 31, 2003, as a result of increased Consumer Division orders booked in the fourth quarter of 2003 compared to the fourth quarter of 2002. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues.

Gross Profit. Our gross profit was $35.9 million in 2003, compared to $32.9 million in 2002. Gross profit as a percentage of revenues was 16.9% in 2003, compared to 18.7% in 2002. Gross profit as a percentage of revenues decreased due primarily to reduced OEM Division gross profit as a percentage of revenues. Gross profit for our OEM Division as a percentage of OEM Division revenues was 22.0% in 2003, compared to 30.1% in 2002. This decrease in gross profit as a percentage of revenues for our OEM Division resulted primarily from a negative shift in product mix. Gross profit for our Consumer Division as a percentage of Consumer Division revenues was 14.9% in 2003, compared to 15.1% in 2002.

Sales and Marketing. Sales and marketing expenses are comprised primarily of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $18.8 million in 2003, compared to $17.5 million in 2002. Sales and marketing expenses as a percentage of revenues were 8.9% in 2003, compared to 9.9% in 2002. Sales and marketing expenses increased due primarily to increased revenues and expanded Consumer Division marketing programs in 2003. Sales and marketing expenses as a percentage of revenues decreased due primarily to leveraging certain fixed sales and marketing costs against a larger revenue base.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $10.1 million in 2003, compared to $10.3 million in 2002. General and administrative expenses as a percentage of revenues were 4.8% in 2003 and 5.9% in 2002. General and ad