TWITTER, INC.
Form 10-Q
May 03, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018

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 001-36164

Twitter, Inc.

(Exact name of registrant as specified in its charter)

Delaware	20-8913779
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1355 Market Street, Suite 900

San Francisco, California 94103

(Address of principal executive offices and Zip Code)

(415) 222-9670

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES NO

The number of shares of the registrant's common stock outstanding as of April 25, 2018 was 752,666,518.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q 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, which statements involve substantial risks and uncertainties. Forward-looking statements generally relate to future events or our future financial or operating performance. In some cases, you can identify forward-looking statements because they contain words such as “may,” “will,” “should,” “expects,” “plans,” “anticipates,” “could,” “intends,” “target,” “projects,” “believes,” “estimates,” “predicts,” “potential” or “continue” or the negative of these words or other similar terms or expressions that concern our expectations, strategy, plans or intentions. Forward-looking statements contained in this Quarterly Report on Form 10-Q include, but are not limited to, statements about:

- our ability to attract and retain users and increase the level of engagement, including ad engagement, of our users;
- our expectations regarding MAUs, changes in DAUs, changes in cost per ad engagement and changes in ad engagements;
- our ability to develop or acquire new products, product features and services, improve our existing products and services, including with respect to Promoted Tweet product features, video and performance advertising, and increase the value of our products and services;
- our business strategies, plans and priorities, including our plans for growth and hiring, investment in and refinement of our products and services;
- our ability to provide new content from third parties, including our ability to secure live streaming video content on terms that are acceptable to us;
- our ability to attract advertisers to our platforms, products and services and increase the amount that advertisers spend with us;
- our expectations regarding our user growth and growth rates and the continued usage of our mobile applications, including the impact of seasonality and a recent change to the Apple Safari interface;
- our plans regarding user safety, including our expectations regarding policies, enforcement and preventing manipulation of our platform;
- our ability to increase our revenue and our revenue growth rate, including by differentiating and scaling revenue products and our expectations regarding revenue mix;
- our expectations regarding revenue growth vis-à-vis audience growth, competition and the effects of advertiser sales cycle and product deprecation;
- our ability to improve user monetization;
- our future financial performance, including trends in cost per ad engagement, revenue, cost of revenue, operating expenses, including stock-based compensation and income taxes; our expectations regarding our tax expense and cash taxes;
- the impact of the 2017 Tax Cuts and Jobs Act on our results of operations;
- our expectations regarding outstanding litigation;
- the effects of seasonal trends on our results of operations;
- the impact of our recent financial results on our valuation allowance for federal and state deferred tax assets;
- the sufficiency of our cash and cash equivalents and cash generated from operations to meet our working capital and capital expenditure requirements;
- our ability to timely and effectively develop, invest in, scale and adapt our existing technology and network infrastructure;
- our ability to successfully acquire and integrate companies and assets; and
- our expectations regarding international operations and foreign exchange gains and losses.

We caution you that the foregoing list may not contain all of the forward-looking statements made in this Quarterly Report on Form 10-Q.

You should not rely upon forward-looking statements as predictions of future events. We have based the forward-looking statements contained in this Quarterly Report on Form 10-Q primarily on our current expectations and projections about future events and trends that we believe may affect our business, financial condition, operating results, cash flows or prospects. The outcome of the events described in these forward-looking statements is subject to risks, uncertainties and other factors described in the section titled “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time and it is not possible for us to predict all risks and uncertainties that could have an impact on the forward-looking statements contained in this Quarterly Report on Form 10-Q. We cannot assure you that the results, events and circumstances reflected in the forward-looking statements will be achieved or occur, and actual results, events or circumstances could differ materially from those described in the forward-looking statements.

The forward-looking statements made in this Quarterly Report on Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statements made in this Quarterly Report on Form 10-Q to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q or to reflect new information or the occurrence of unanticipated events, except as required by law. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

NOTE REGARDING KEY METRICS

We review a number of metrics, including monthly active users, or MAUs, changes in daily active users or daily active usage, or DAUs, changes in ad engagements and changes in cost per ad engagement, to evaluate our business, measure our performance, identify trends affecting our business, formulate business plans and make strategic decisions. See the section titled “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Key Metrics” for a discussion of how we calculate MAUs, changes in DAUs, changes in ad engagements and changes in cost per ad engagement.

The numbers of active users presented in this Quarterly Report on Form 10-Q are based on internal company data. While these numbers are based on what we believe to be reasonable estimates for the applicable period of measurement, there are inherent challenges in measuring usage and user engagement across our large user base around the world. Furthermore, our metrics may be impacted by our information quality efforts, which are our overall efforts to reduce malicious activity on the service, inclusive of spam, malicious automation, and fake accounts. For example, there are a number of false or spam accounts in existence on our platform. We have performed an internal review of a sample of accounts and estimate that false or spam accounts represented fewer than 5% of our MAUs as of December 31, 2017. In making this determination, we applied significant judgment, so our estimation of false or spam accounts may not accurately represent the actual number of such accounts, and the actual number of false or spam accounts could be higher than we have estimated. We are continually seeking to improve our ability to estimate the total number of spam accounts and eliminate them from the calculation of our active users, and have made improvements in our spam detection capabilities that have resulted in the suspension of a large number of spam, malicious automation and fake accounts. We intend to continue to make such improvements. After we determine an account is spam, malicious automation or fake, we stop counting it in our MAU, DAU or related metrics. Additionally, we rely on third-party SMS aggregators and mobile carriers to deliver SMS messages to certain of our users when we send our SMS messages to such accounts. If, however, we are notified of material deliverability issues because of, for example, infrastructure issues at the service-provider level or governmental restrictions based on content, we do not include the affected users in MAUs. We also treat multiple accounts held by a single person or organization as multiple users for purposes of calculating our active users because we permit people and organizations to have more than one account. Additionally, some accounts used by organizations are used by many people within the organization. As such, the calculations of our active users may not accurately reflect the actual number of people or organizations using our platform.

Certain metrics also include users that access Twitter through applications that automatically contact our servers for regular updates with no discernible user-initiated action involved, which we refer to as third-party auto-polling MAU. This activity causes our system to count MAUs associated with such applications as active users on the day or days such contact occurs. As of December 31, 2017, fewer than 8.5% of MAUs may have been third-party auto-polling MAU.

In addition, our data regarding user geographic location for purposes of reporting the geographic location of our MAUs is based on the IP address or phone number associated with the account when a user initially registered the account on Twitter. The IP address or phone number may not always accurately reflect a user’s actual location at the time such user engaged with our platform. For example, a mobile user may appear to be accessing Twitter from the location of the proxy server that the user connects to rather than from a user’s actual location.

We regularly review and may adjust our processes for calculating our internal metrics to improve their accuracy. Our measures of user growth and user engagement may differ from estimates published by third parties or from similarly-titled metrics of our competitors due to differences in methodology.

Our total audience metrics are based on both internal metrics and data from Google Analytics, which measures logged-out visitors to our properties.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

TWITTER, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

(Unaudited)

	March 31, 2018	December 31, 2017
s:		
n	$1,601,028	$1,638,413
	2,927,803	2,764,689
t		
,		
	611,840	664,268
	268,564	254,514
	5,409,235	5,321,884
	801,912	773,715
et		
	44,794	49,654
	1,190,932	1,188,935
	92,568	78,289

$7,539,441 $7,412,477e acquired a majority ownership of Emosyn LLC on September 10, 2004. On April 15, 2005, we acquired th minority interest of Emosyn. As a result of the acquisition of the remaining minority interest, the manageme Emosyn's products was integrated into ASPG. Effective for the second quarter of 2005, Emosyn is no longer considered as reportable segment by our key decision makers and Emosyn's flash memory based smart-card IC's are now included in ASPG. Our revenues and gross margin information have been reclassified for presentation purposes as if the transfer occurred as of September 1 revenues were $30.5 million for the second quarter of 2005, as compared to $27.7 million for the first quarter of 2005 and $15.7 mil second quarter of 2004. Unit shipments increased 21.4% in the second quarter of 2005 from the first quarter of 2005 largely due to i shipments of serial products by 78.3%, offset by a 9.3% decrease in unit shipments of smartcard IC products. The increase in unit sh offset by a 10.0% decrease in average selling prices of our products. The net impact of the increase in unit shipments and decrease i prices resulted in a 10.0% increase in revenue for the second quarter of 2005 as compared first quarter of 2005. The 94.6% increase second quarter of 2005 from the second quarter of 2004 was a result of a 190.0% increase in unit shipments, offset by a 32.5% decre selling prices. 42.0% of the unit shipment increase relates to the smart-card IC products due to the acquisition of Emosyn and 43.2% related to increases in serial product shipments. Revenue was $58.3 million for the six months ended June 30, 2005 as compared to the comparable period of 2004.

ASPG gross margin decreased from 32.3% in the first quarter of 2005 and from 32.4% in the second quarter 6.4% in the second quarter of 2005. The decrease from the first quarter of 2005 is primarily due to a 10.0% average selling prices and a $1.5 million increase in provisions for inventory and adverse purchase commitm to lower of cost or market and excess inventory adjustments. The decrease in gross margin from the second 2004 is primarily due to a 32.5% decrease in average selling price of our product due to increased competiti product mix. Gross margin was 18.7% for the six months ended June 20, 2005 as compared to 31.1% for the ended June 30, 2005. The decrease in gross margin was primarily due to a 30.0% decrease in average sellin ASPG products due to increased competition and product mix.

SPG includes ComboMemory, ROM/RAM Combos, SSF, MTP, FlashFlex51 microcontrollers and other sp products. SPG revenues were $7.5 million for the second quarter of 2005, as compared to $6.7 million in the of 2005 and $12.3 million in the second quarter of 2004. The decrease in revenues from the first quarter of 2 primarily due to a 2.6% decrease in average selling prices, offset by a 10.0% increase in unit shipments. The revenues from the second quarter of 2004 was primarily due to a 27.3% decrease in unit shipments and a 13. in average selling prices. Revenue for the six months ended June 30, 2005 was $14.2 million, as compared t million in the comparable quarter of 2004. The decrease in revenue for the six months ended June 30, 2005 to the comparable quarter of 2004 is primarily due to a 24.0% decrease in unit shipments and a 10.6% decre average selling price of SPG products.

SPG gross margin for the second quarter of 2005 was 9.1%, as compared to 6.1% in the first quarter of 2005 in the second quarter of 2004. The increase in the second quarter of 2005 from the first quarter of 2005 is pr $1.1 million higher provisions for inventory and adverse purchase commitments related to lower of cost or excess inventory adjustments in the first quarter of 2005 as compared to the second quarter of 2005. The de gross margin from the second quarter of 2004 is primarily due to a 12.8% decrease in average selling prices product. Gross margin was 7.7% for the six months ended June 30, 2005, compared to 29.1% for the compa of 2004. The decrease in gross margin is primarily due to a 10.6% decrease in the average selling price of S and a $1.8 million increase in provision for inventory and adverse purchase commitments related to lower o market and excess inventory in the first half of 2005.

SCC includes RF transmitter, receiver, synthesizer, power amplifier and switch products. We formed SST Communications Corporation and acquired substantially all of the assets of G-Plus, Inc. on November 5, 20 revenues were $748 thousand for the second quarter of 2005, as compared to $683 thousand for the first quarter of 2005. Revenues months ended June 30, 2005 were $1.4 million.

SCC gross margin was negative 4.8% and negative 7.8% for the first and second quarter of 2005, respective margin for the six months ended June 30, 2005 was negative 6.4%. The negative gross margin is primarily a

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result of a $411 thousand provision for inventory in the first half of 2005.

Revenue and gross profit related to technology licensing was $8.4 million in the second quarter of 2005, as c
$7.0 million in the first quarter of 2005 and $13.0 million in the second quarter of 2004. Revenue and gross
to technology licensing was $15.5 million for the six months ended June 30, 2005 as compared to $26.0 mill
comparable period of 2004. Revenues from license fees and royalties are recognized upon the licensees' acce
delivery of our engineering milestones and the reported royalty of our licensees based on their shipments, re
The increase in revenue in the second half of 2005 as compared to the first half of 2005 relates to the reporte
our licensees. The decease in revenue in the second quarter of 2005 and the six months ended June 30, 2005
to the second quarter of 2004 and the six months ended June 30, 2004 is due to higher license fees from new
the first half of 2004. Revenues from technology licensing fluctuate upon the timing of the delivery of engin
milestones. We anticipate that revenues from technology licensing may fluctuate significantly in the future.

Related Party Transactions and Balances

The following table is a summary of our related party revenues and purchases for the three and six months e
2004 and 2005, and our related party accounts receivable and accounts payable and accruals as of December
and June 30, 2005 (in thousands). For a description of our relationship with these parties please see "Manage
Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions" in c
Report on Form 10- K for the year ended December 31, 2004.

	Three Months Ended June 30, 2004		Three Jur
	Revenues	**Purchases**	**Revenues**
Silicon Technology Co., Ltd................	$ 2,742	$ --	$ 1,13
Apacer Technology, Inc. & related entities..	754	--	51
Silicon Professional Technology Ltd.........	65,551	--	46,35
Grace Semiconductor Manufacturing Corp......	--	16,411	2
King Yuan Electronics Company, Limited......	--	9,416	-
Powertech Technology, Incorporated.........	--	3,881	-
	$ 69,047	$ 29,708	$ 48,03

	Six Months Ended June 30, 2004		Six Jur
	Revenues	**Purchases**	**Revenues**
Silicon Technology Co., Ltd................	$ 4,338	$ --	$ 1,83
Apacer Technology, Inc. & related entities..	1,349	707	84
Silicon Professional Technology Ltd.........	121,919	--	86,97
Grace Semiconductor Manufacturing Corp......	--	23,360	13
King Yuan Electronics Company, Limited......	--	17,601	-
Powertech Technology, Incorporated.........	--	7,077	-
	$ 127,606	$ 48,745	$ 89,79

	December 31, 2004		June
	Trade Accounts Receivable	**Trade Accounts Payable and Accruals**	**Trade Accounts Receivabl**
Silicon Technology Co., Ltd................	$ 322	$ --	$ 30
Apacer Technology, Inc. & related entities..	458	320	61
Professional Computer Technology Limited....	--	72	-
Silicon Professional Technology Ltd.........	32,037	694	27,56
Grace Semiconductor Manufacturing Corp......	156	17,227	28
King Yuan Electronics Company, Limited......	--	13,702	-
Powertech Technology, Incorporated.........	--	3,867	-
	$ 32,973	$ 35,882	$ 28,76

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PCT continues to earn commissions for point-of-sales to its customers. PCT's commissions are paid at the sa
of our other stocking representatives in Asia. In addition, we continue to pay SPT a fee for providing logistic
functions. This fee is based on a percentage of revenue for each product shipped through SPT to our end cus
fee paid to SPT covers the costs of warehousing and insuring inventory and accounts receivable, the personn
required to maintain logistics and information technology functions and the costs to perform billing and coll
accounts receivable.

Liquidity and Capital Resources

Operating activities.

Our operating activities used cash of $47.6 million for the six months ended June 30, 2005 as compared to $
for the six months ended June 30, 2004. Our net loss of $33.5 million for the six months ended June 30, 200
non-cash charges of $23.7 million for provision against inventory, $4.7 million of depreciation and amortiza
million for purchasing in process research and development and $1.7 million for provision of sales returns. I
our net loss, the primary usage of cash related to an increase in inventory of $33.2 million, decreased accoun
from related and unrelated parties of $21.5 million and a decrease in accrued expenses and other liabilities o
million. While inventory increased for the six months ended June 30, 2005, the increase was concentrated in
part of the first quarter of 2005 for production that was started in the fourth quarter of 2004 and early 2005 a
shipment volumes of our mid-density and smart card IC products. We reduced wafer starts during the first q
2005 and as a result, inventory began to decrease as we shipped previously purchased inventory. We anticip
inventory levels will continue to decrease through at least the third quarter of 2005. The reduction in the rela
unrelated trade accounts payable is related to a combination of the payment of the higher inventory related p
late 2004 and early 2005 and current lower purchasing activities. Overall cash used in operating activities wa
due to cash provided from decreases in accounts receivable from related and unrelated parties, other current
non-current assets and deferred revenue of $8.9 million, $3.2 million and $572 thousand, respectively. For th
ended June 30, 2004, our primary usage of operating cash flow were the increased purchases of inventory an
accounts receivable from both related and unrelated parties offset by the increase of accounts payable to both
unrelated parties. The increase of accounts receivable from both related and unrelated parties is due to the in
sales during the period. We measure the effectiveness of our collection efforts by an analysis of average day
outstanding. Days sales outstanding was 47 days in the second quarter of 2005 as compared to 61 days in the
quarter of 2004. Collections of accounts receivable and related days sales outstanding will fluctuate in future
to the timing and amount of our future revenues, customer payment terms and the effectiveness of our collec

Investing activities.

Our investing activities provided cash of $54.6 million for the first six months of 2005 as compared to a cash
$32.2 million for the first six months of 2004. Cash provided by investing activities in the first half of 2005 v
attributable to $65.4 million of cash from the net sales and maturities of available-for-sale investments, offse
million net cash used in the acquisition of Actrans and the minority interest of Emosyn, $2.6 million in capit
expenditures and $333 thousand in equity investments. In the first half of 2004, cash used in investing activi
our additional investments in Grace Semiconductor Manufacturing Corporation of $33.2 million, new equity
in ACET of $4.0 million and capital expenditures of $2.2 million, offset by net sales of available-for-sale in
$7.8 million.

Financing activities.

Our financing activities provided cash of $4.5 million and $3.3 million during the first six months of 2005 a
respectively. Cash generated from financing activities in the first half of 2005 primarily related to the borrow
the line of credit of $3.0 million and the issuance of common stock under the employee stock purchase plan
exercise of employee stock options totaling $1.7 million. In the first half of 2004, cash generated from financ
activities primarily related to issuance of common stock under the employee stock purchase plan and the exe
employee stock options totaling $3.5 million.

Principal sources of liquidity at June 30, 2005 consisted of $50.2 million of cash, cash equivalents, and short
available-for-sale investments.

As of June 30, 2005, other than as described below, there were no material changes in long-term debt obliga
lease obligations, operating lease obligations, purchase obligations or any other long-term liabilities reflecte
condensed consolidated balance sheet as compared to December 31, 2004.

Purchase Commitments.

As of June 30, 2005, we had outstanding purchase commitments with our foundry vendors of $50.4 million
in 2005. We have recorded a liability of $1.1 million for adverse purchase commitments. In comparison, as
31, 2004, we had outstanding purchase commitments with our foundry vendors of $100.7 million for deliver
with a recorded liability of $8.3 million for adverse purchase commitments.

Lease Commitments. We have long-term, non-cancelable building lease commitments. In 2001 and the secon
2004, we recorded charges to other operating expense of $756 thousand and $1.5 million, respectively, relat
operating leases for unoccupied buildings. These charges represent the estimated difference between the tota
future sublease income and our discounted lease commitments relating to these buildings. At December 31,
June 30, 2005, payments made have reduced the recorded liability to $976 thousand and $425 thousand, resp

Operating Capital Requirements. We believe our cash balances, together with the funds we expect to genera
operations, will be sufficient to meet our projected working capital and other cash requirements through at le
twelve months. We believe that our operations will provide positive cash flow by the end of 2005, based on
increased revenues over the current period and our focused efforts to reduce inventory levels. However, if w
execute to plan, we could experience a further decline in our cash balances. We are in the process of negotia
credit to help provide additional liquidity as we execute to plan. However, there can be no assurance that fut
will not require us to seek additional borrowings or capital and, if so required, that such borrowing or capital
available on acceptable terms. Factors that could affect our short-term and long-term cash used or generated
operations and as a result, our need to seek additional borrowings or capital include:

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

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

In January and February 2005, multiple putative shareholder class action complaints were filed against us an
directors and officers in the United States District Court for the Northern District of California. Following th
the putative class action lawsuits, multiple shareholder derivative complaints were filed in California Superi
the County of Santa Clara, purportedly on behalf of SST against certain directors and officers. In the event o
outcome of the suits, we may be required to pay damages. For more information, please also see "Business R
become engaged in securities class action suits and derivative suits, we may become subject to consuming a
litigation and divert management resources and could impact our stock price."

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We
certain costs associated with defending these matters. There can be no assurance that the shareholder class a
complaints, the shareholder derivative complaints or other third party assertions will be resolved without cos
in a manner that is not adverse to our financial position, results of operations or cash flows or without requir
payments in the future which may adversely impact gross margins. No estimate can be made of the possible
possible range of loss associated with the resolution of these contingencies. As a result, no losses have been
our financial statements as of June 30, 2005.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS 123R (revised 2004), or SFAS 123R, "Share Based Payment." S
a revision of FASB 123 and supersedes APB No. 25. SFAS 123R establishes standards for the accounting fo
transactions in which an entity exchanges its equity instruments for good or services or incurs liabilities in ex
goods or services that are based on the fair value of the entity's equity instruments. SFAS 123R focuses prim

accounting for transactions in which an entity obtains employee services in share-based payment transaction
123R requires an entity to measure the cost of employee services received in exchange for an award of equit
based on the grant-date fair value of the award over the period during which an employee is required to prov
for the award. The grant-date fair value of employee share options and similar instruments must be estimatec
option-pricing models adjusted for the unique characteristics of those

instruments unless observable market prices for the same or similar instruments are available. In addition, SI
requires that a public entity measure the cost of employee services received in exchange for an award of liab
instruments based on its current fair value and that the fair value of that award will be remeasured subsequen
reporting date through the settlement date. In April 2005, the U. S. Securities and Exchange Commission ad
rule that amends the compliance dates of SFAS 123R. The effective date of SFAS 123R for us is the first int
of 2006. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts th
to the current pro forma disclosures under SFAS123, we are evaluating the requirements under SFAS 123R
the adoption to have a significant adverse impact on our consolidated operating expenses.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107, or SAB 107. SAB 107 includes interpret
for the initial implementation of FAS 123R. The Company will apply the principles of SAB 107 in conjunct
adoption of FAS 123R.

In May 2005, the FASB issues SFAS No. 154, "Accounting Changes and Error Corrections", or SFAS 154.
replaces APB Opinion No. 20 "Accounting Changes" and SFAS No. 3, Reporting Accounting Changes in In
Financial Statements". SFAS 154 requires retrospective application to prior periods' financial statements of c
accounting principle, unless it is impractical to determine either the period-specific effects or the cumulative
change. We do not expect the adoption of SFAS No. 154 to have a material impact on our consolidated finan
statements.

Business Risks

Risks Related to Our Business

Our operating results fluctuate materially, and an unanticipated decline in revenues may disappoint securitie
investors and result in a decline in our stock price.

Although we were profitable for the first three quarters of 2004, we incurred net losses for 2001, 2002, 2003
quarter of 2004 and the first half of 2005. Our operating results have fluctuated significantly and our past fin
performance should not be used to predict future operating results. Our recent quarterly and annual operating
fluctuated, and may continue to fluctuate, due to the following factors, all of which are difficult to forecast a
which are out of our control:

- the availability, timely delivery and cost of wafers or other manufacturing and assembly services fro suppliers;
- competitive pricing pressures and related changes in selling prices;
- fluctuations in manufacturing yields and significant yield losses;
- new product announcements and introductions of competing products by us or our competitors;
- product obsolescence;
- lower of cost or market, obsolescence or other inventory adjustments;
- changes in demand for, or in the mix of, our products;
- the gain or loss of significant customers;
- market acceptance of products utilizing our SuperFlash® technology;
- changes in the channels through which our products are distributed and the timeliness of receipt of d resale information;
- exchange rate fluctuations;
- general economic, political and environmental-related conditions, such as natural disasters;
- increases in allowance for doubtful accounts;

- valuation allowances on deferred tax assets based on changes in estimated future taxable income;
- difficulties in forecasting, planning and management of inventory levels;
- unanticipated research and development expenses associated with new product introductions; and
- the timing of significant orders and of license and royalty revenue.

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

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

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

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

In addition, political or economic events beyond our control can suddenly result in increased operating costs
example, the terrorist attacks of September 11, 2001 have resulted in a substantial increase to our business ir
costs. In addition, under a recently approved standard, we will be required to record compensation expense o
option grants, which may substantially increase our operating costs and impact our earnings (loss) per share.

We incurred significant inventory valuation adjustments in 2003, 2004 and the first half of 2005, and v
additional significant inventory valuation adjustments in the future.

We typically plan our production and inventory levels based on internal forecasts of customer demand, whic
unpredictable and can fluctuate materially. The value of our inventory is dependent on our estimate of future
selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust o
value to reflect the lower of cost or market. If we over estimate future market demand, we may have excess
levels that cannot be sold within a normal operating cycle and we may be required to take a valuation adjust
excess inventory. As of June 30, 2005, we had $159.6 million of net inventory on hand, an increase of $3.0
1.9%, from December 31, 2004 and a decrease of $16.6 million, or 9.4%, from March 31, 2005. Total valuat
adjustments to inventory and adverse purchase commitments were $6.7 million in 2003, $35.9 million in 20
million in the first half of 2005. Due to the large number of units in our inventory, even a small change in av
prices could result in a significant adjustment and could harm our financial results. Some of our customers h
requested that we ship them product that has a finished goods date of manufacture that is less than one year
June 30, 2005, our allowance for excess and obsolete inventories includes an allowance for our on hand finis
inventory with a date of manufacture of greater than two years old and for certain products with a date of ma
greater than one year old. In the event that this becomes a common requirement, it may be necessary for us t
an additional allowance for our on hand finished goods inventory with a date of manufacture of greater than
which could result in a significant adjustment and could harm our financial results. In addition, our allowanc
allowance for die, work-in-process and finished goods that exceed our estimated forecast for the next twelve
four months. If future customer demand decreases, it may be necessary to take an additional valuation adjus
excess inventory.

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

Due to possible customer changes in delivery schedules and cancellations of orders, our backlog at any parti
not necessarily indicative of actual sales for any succeeding period. A reduction of backlog during any partic
or the failure of our backlog to result in future revenue, could harm our business in the future. We experienc
downturn in several of our markets late in 2000 through 2002, as our customers reacted to weakening demar
products. We began to experience a slow recovery during 2002 through the first half of 2003. During the sec
2003 and the first quarter of 2004, demand for our products increased sharply and we began to see improven
average selling prices of our products. However, during the second half of

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2004 and the first half of 2005, we experienced a demand slow-down for our products. Our business could b
industry-wide fluctuations in the future.

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

During 2003, 2004 and the six months ended June 30, 2005, our export product and licensing revenues acco
92.9%, 92.7% and 93.9% of our net revenues, respectively. Our international business activities are subject t
of risks, each of which could impose unexpected costs on us that would harm our operating results. These ri

- difficulties in complying with regulatory requirements and standards;
- tariffs and other trade barriers;
- costs and risks of localizing products for foreign countries;
- reliance on third parties to distribute our products;
- extended accounts receivable payment cycles;
- potentially adverse tax consequences;
- limits on repatriation of earnings; and
- burdens of complying with a wide variety of foreign laws.

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

We derived 90.0%, 86.0% and 85.0% of our net product revenues from Asia during 2003, 2004 and the six
June 30, 2005, respectively. Additionally, substantially all of our wafer suppliers and packaging and testing
subcontractors are located in Asia. Any kind of economic, political or environmental instability in this regio
world can have a severe negative impact on our operating results due to the large concentration of our produ
sales activities in this region. For example, during 1997 and 1998, several Asian countries where we do busi
Japan, Taiwan and Korea, experienced severe currency fluctuation and economic deflation, which negativel
our revenues and also negatively impacted our ability to collect payments from customers. During this perio
capital in the financial sectors of these countries made it difficult for our customers to open letters of credit
financial instruments that are guaranteed by foreign banks. Finally, the economic situation during this perio
a decline in selling prices for our products as our competitors reduced product prices to generate needed cas

It should also be noted that we are greatly impacted by the political, economic and military conditions in Ta
and China are continuously engaged in political disputes and both countries have continued to conduct milit
in or near the other's territorial waters and airspace. Such disputes may continue and even escalate, resulting
economic embargo, a disruption in shipping or even military hostilities. Any of these events could delay pro
shipment of our products. Any kind of activity of this nature or even rumors of such activity could harm our
revenues, operating results, and stock price.

Terrorist attacks and threats, and government responses thereto, could harm our business.

Terrorist attacks in the United States or abroad against American interests or citizens, U.S. retaliation for the
threats of additional terrorist activity and the war in Iraq have caused our customer base to become more ca
escalation in these events or similar future events may disrupt our operations or those of our customers, dist
suppliers, affect the availability of materials needed to manufacture our products, or affect the means to tran

materials to manufacturing facilities and finished products to customers. In addition, these events have had a
continue to have an adverse impact on the U.S. and world economy in general and consumer spending in par
which could harm our business.

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

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

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

We rely on stocking representatives and distributors to establish and maintain customer relationships and to
products. These stocking representatives and distributors could discontinue their relationship with us or disc
selling our products at any time. The majority of our stocking representatives are located in Asia. The loss o
relationship with any stocking representative or distributor could harm our operating results by impairing ou
sell our products to our end customers.

We depend on SPT, our logistics center, to support many of our customers in Asia.

Since 2001, we have been increasing our out-sourcing activities with our customer service logistics to suppo
customers. Currently SPT supports our customers in Taiwan, China and other Southeast Asia countries. SPT
planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT i
owned subsidiary of one of our stocking representatives in Taiwan, PCT. During 2003, 2004 and the six mo
June 30, 2005, SPT serviced end customer shipments accounted for 64.2%, 52.9% and 53.0% of our net pro
recognized, respectively. As of December 31, 2004 and June 30, 2005, the accounts receivable from SPT ac
55.1% and 57.7%, respectively, of our net accounts receivable. For further description of our relationships w
SPT, please refer to "Management's Discussion and Analysis of Financial Condition and Results of Operatio
Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2004.

We do not have any long-term contracts with SPT, PCT or SPAC, and SPT, PCT or SPAC may cease provi
to us at any time. If SPT, PCT or SPAC were to terminate their relationship with us we would experience a
reestablishing warehousing, logistics and distribution functions, which could impair our ability to collect ac
receivable from SPT and may harm our business.

We depend on a limited number of foreign foundries to manufacture our products, and these foundries may
satisfy our manufacturing requirements, which could cause our revenues to decline.

We outsource substantially all of our manufacturing and testing activities. We currently buy all of our wafer
die from a limited number of suppliers. The majority of our products are manufactured by five foundries, TS
Taiwan, Seiko-Epson and Yasu in Japan and Grace and Shanghai Hua Hong NEC Electronic Company Lim
HHNEC in China. We have invested $83.2 million in GSMC, a Cayman Islands company, which owns a wa
subsidiary, Grace, in Shanghai, China. We anticipate that these foundries, together with Sanyo in Japan, Sa
Korea and Vanguard and Powerchip Semiconductor Corporation, or PSC, in Taiwan will manufacture subst
our products in 2005. If these suppliers fail to satisfy our requirements on a timely basis at competitive price
suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of
harm our operating results.

Our revenues may be impacted by our ability to obtain adequate wafer supplies from our foundries. The fou
which we currently have arrangements, together with any additional foundry at which capacity might be obt
not be willing or able to satisfy all of our manufacturing requirements on a timely basis at favorable prices. I

we have encountered delays in qualifying new products and in ramping-up new product production and we c
experience these delays in the future. We are also subject to the risks of service disruptions, raw material sho
price increases by our foundries. Such disruptions, shortages and price increases could harm our operating re

Manufacturing capacity has in the past been difficult to secure and if capacity constraints arise in the future
may decline.

In order to grow, we need to increase our present manufacturing capacity. We currently believe that the exis
plus additional future capacity from PSC available to us will be sufficient through 2005. However, events th
not foreseen could arise which would limit our capacity. Similar to our aggregate $83.2 million investment i
may determine that it is necessary to invest substantial capital in order to secure appropriate production capa
commitments. If we cannot secure additional manufacturing capacity on acceptable terms, our ability to gro
impaired and our operating results will be harmed.

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

future.

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

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

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

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

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

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

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

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

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

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

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

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

We compete with major domestic and international semiconductor companies, many of which have substant
financial, technical, marketing, distribution, and other resources than we do. Many of our competitors have t
facilities for the production of semiconductor memory components and have recently added significant capa
production. Our low density memory products, which presently account for substantially all of our revenues
against products offered by Spansion (AMD/Fujitsu), Atmel, Macronix, STMicroelectronics, PMC and Win
medium-density memory products compete with products offered by Spansion, Intel, STMicroelectronics, M
Samsung, Sharp Electronics and Toshiba. If we are successful in developing our high-density products, thes
will compete principally with products offered by Spansion (AMD/Fujitsu), Hynix, Intel, Renesas, Samsung
STMicroelectronics and Toshiba, as well as any new entrants to the market.

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

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

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

The markets for our products are characterized by:

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

To develop new products for our target markets, we must develop, gain access to and use leading technologi
cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we
our products designed into our customers' future products and maintain close working relationships with key

in order to develop new products that meet their changing needs.

In addition, products for communications applications are based on continually evolving industry standards.
to compete will depend on our ability to identify and ensure compliance with these industry standards. As a
could be required to invest significant time and effort and incur significant expense to redesign our products
compliance with relevant standards. We believe that products for these applications will

encounter intense competition and be highly price sensitive. While we are currently developing and introduc
products for these applications, we cannot assure you that these products will reach the market on time, will
address customer needs, will be sold in high volume, or will be sold at profitable margins.

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

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

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

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

We rely on a combination of patent, trade secrets, copyrights, mask work rights, nondisclosure agreements a
contractual provisions and technical measures to protect our intellectual property rights. Policing unauthoriz
products, however, is difficult, especially in foreign countries. Litigation may continue to be necessary in th
enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of th
rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substanti
diversion of resources and could harm our business, operating results and financial condition regardless of th
the litigation. We own 145 patents in the United States relating to our products and processes, with expiratio
ranging from 2010 to 2023, and have filed for several more. In addition, we hold several patents in Europe a
and have filed several foreign patent applications in Europe, Japan, Korea, Taiwan and Canada. We cannot a
that any pending patent application will be granted. Our operating results could be harmed by the failure to p
intellectual property.

If we become engaged in securities class action suits and derivative suits, we may become subject to consum
costly litigation and divert management resources and could impact our stock price.

Securities class action law suits are often brought against companies, particularly technology companies, fol
periods of volatility in the market price of their securities. Irrespective of the validity or the successful assert
claims, we could incur significant costs and management resources in defending against such claims.

In January and February 2005, multiple putative shareholder class action complaints were filed against us an
directors and officers in the United States District Court for the Northern District of California, following ou

announcement of anticipated financial results for the fourth quarter of 2004. On March 24, 2005, the putativ
actions were consolidated and on May 3, 2005, a lead plaintive and a lead counsel were appointed. The lead
a Consolidated Amended Class Action Complaint on July 15, 2005. The complaints seek unspecified damag
violations of federal securities laws during the period from April 21, 2004 to December 20, 2004.

In January and February 2005, following the filing of the putative class action lawsuits, multiple shareholder
complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of

SST against certain directors and officers. The factual allegations of these complaints are substantially ident
contained in the putative shareholder class actions filed in federal court. The derivative complaints assert cla
among other things, breach of fiduciary duty and violations of the California Corporations Code.

Public announcements may hurt our stock price.

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

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

We have incurred certain costs associated with defending these matters, and at any time, additional claims m
against us, which could increase the risk, expense and duration of the litigation. Further, because of the amou
discovery required in connection with this type of litigation, there is a risk that some of our confidential info
could be compromised by disclosure. For more information with respect to our litigation, please also see "Pa
Legal Proceedings."

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

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

In the past we were sued both by Atmel Corporation and Intel Corporation regarding patent infringement iss
Winbond Electronics Corporation regarding our contractual relationship with them. Significant management
financial resources have been devoted to defending or prosecuting these lawsuits. We settled with Intel in M
with Winbond in October 2000, and Atmel in June 2005.

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

Public announcements may hurt our stock price.

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

Litigation may be expensive, may be protracted and confidential information may be compromised.

During the course of lawsuits, we may incurred certain costs associated with defending or prosecuting these
addition, because substantial amounts of discovery may be required in connection with this type of litigation
risk that some of our confidential information could be compromised by disclosure. For more information w
our litigation, please also see "Part II, Item 1- Legal Proceedings."

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

Our corporate headquarters are located in California near major earthquake faults. In addition, some of our s
located near fault lines. In the event of a major earthquake or other natural disaster near our headquarters, ou

operations could be harmed. Similarly, a major earthquake or other natural disaster such as typhoon near one
our major suppliers, like the earthquakes in September 1999 and March 2002 or the typhoons in September 2
2005 that occurred in Taiwan, could potentially disrupt the operations of those suppliers, which could then li
supply of our products and harm our business.

A virus or viral outbreak in Asia could harm our business.

We derive substantially all of our revenues from Asia and our logistics center is located in Taiwan. A virus o
outbreak in Asia, such as the SARS outbreak in early 2003, could harm the operations of our suppliers, distr
logistics center and those of our end customer, which could harm our business.

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

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

Our growth has in the past placed a significant strain on our management systems and resources and if we fa
our growth, our ability to market or sell our products or develop new products may be harmed.

Our business has in the past experienced rapid growth which strained our internal systems and future growth
us to continuously develop sophisticated information management systems in order to manage our business e
We recently implemented a supply-chain management system and a vendor electronic data interface system.
guarantee that these measures, in themselves, will be adequate to address any growth, or that we will be able
a timely manner other infrastructure needs before they arise. Our success depends on the ability of our execu
to effectively manage our growth. If we are unable to manage our growth effectively, our results of operation
harmed. If we fail to successfully implement new management information systems, our business may suffer
inefficiencies that may harm the results of our operations.

Future changes in financial accounting standards or practices or existing taxation rules or practices may caus
unexpected revenue fluctuations and affect our reported results of operations.

A change in accounting standards or practices or a change in existing taxation rules or practices can have a s
effect on our reported results and may even affect our reporting of transactions completed before the change
New accounting pronouncements and taxation rules and varying interpretations of accounting pronounceme
taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of c
practices may adversely affect our reported financial results or the way we conduct our business.

For example, changes requiring that we record compensation expense in the statement of operations for stoc
using the fair value method or changes in existing taxation rules related to stock options could have a signifi
effect on our reported results. The FASB has issued changes to generally accepted accounting principles in t
States that, when implemented in the first quarter of 2006, will require us to record charges to earnings for th
options we grant.

Evolving regulation of corporate governance and public disclosure may result in additional expenses and co
uncertainty

Changing laws, regulations and standard relating to corporate governance and public disclosure, including th
Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ National Market rules are creating uncert
public companies. We continually evaluate and monitor developments with respect to new and proposed rul
predict or estimate the amount of the additional costs we may incur or the timing of such costs. These new o

changed laws, regulations and standards are subject to varying interpretations, in many cases due to their lac
specificity, and as a result, their application in practice may evolve over time as new guidance is provided by
and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher c
necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining
standards of corporate governance and public disclosure. As a result, we have invested resources to comply
laws, regulations and standards, and this investment has resulted in increased general and administrative exp
may result in a diversion of management time and attention from revenue-generating activities to complianc
our efforts to comply with new or changed laws, regulations and standards differ from the activities intended
regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate lega
against us and we may be harmed.

We, and our independent registered public accounting firm, have determined that we have a material weakn
internal control over financial reporting. As a result, current and potential stockholders could lose confidenc
financial reporting, which would harm our business and the trading price of our stock.

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effecti
internal controls over financial reporting. We dedicated a significant amount of time and resources to ensure
with this legislation for the year ended December 31, 2004 and will continue to do so for future fiscal period
encounter problems or delays in completing the review and evaluation, the implementation of improvements
receipt of a positive attestation, or any attestation at all, by our independent registered public accounting firn
Additionally, management's assessment of our internal control over financial reporting may identify deficier
need to be addressed in our internal control over financial reporting or other matters that may raise concerns

As of December 31, 2004, we did not maintain effective control over accounting for and review of the valua
inventory, the income tax provision and related balance sheet accounts and licensing revenue because we lac
sufficient complement of personnel with a level of accounting expertise that is commensurate with our finan
requirements. Specifically, we lacked sufficient controls over the write down of inventory to the lower of co
accounting for complex licensing contracts with multiple elements, and processes and procedures related to
determination and review of the quarterly and annual tax provisions in accordance with generally accepted a
principles in the United States. This control deficiency resulted in an audit adjustment to the 2004 consolida
statements related to the write-down of inventory to the lower of cost or market. Because of this material we
management concluded that, as of December 31, 2004, we did not maintain effective internal control over fi
reporting based on those criteria. As a result, PricewaterhouseCoopers LLP, issued an adverse opinion with
internal control over financial reporting and their report is included in our Annual Report on Form 10-K for
ended December 31, 2004. We have taken measures designed to address this material weakness as further di
"Part I - Item 4. Controls and Procedures."

Should we, or our independent registered public accounting firm, determine in future fiscal periods that we h
additional material weaknesses in our internal control over financial reporting, the reliability of our financial
be impacted, and our results of operations or financial condition may be harmed and the price of our commo
decline.

Acquisitions could result in operating difficulties, dilution and other harmful consequences.

In September 2004 we acquired majority ownership in Emosyn, in November 2004 we acquired substantiall
assets of G-Plus and in April 2005, we acquired all of the outstanding capital stock of Actrans and acquired
minority interest in Emosyn. We expect to continue to evaluate and consider a wide array of potential strateg
transactions, including business combinations, acquisitions and dispositions of businesses, technologies, ser

products and other assets, including interests in our existing subsidiaries and joint ventures. At any given tim
engaged in discussions or negotiations with respect to one or more of such transactions. Any of such transac
be material to our financial condition and results of operations. There is no assurance that any such discussio
negotiations will result in the consummation of any transaction. The process of integrating any acquired bus
create unforeseen operating difficulties and expenditures and is itself risky. The areas where we may face di
include:

- diversion of management time, as well as a shift of focus from operating the businesses to issues of and future products;
- declining employee morale and retention issues resulting from changes in compensation, reporting future prospects, or the direction of the business;
- the need to integrate each company's accounting, management information, human resource and oth administrative systems to permit effective management, and the lack of control if such integration is not implemented;
- the need to implement controls, procedures and policies appropriate for a public company at compa to acquisition had lacked such controls, procedures and policies; and in some cases, the need to tran operations onto our platforms.

International acquisitions involve additional risks, including those related to integration of operations across cultures and languages, currency risks, and the particular economic, political, and regulatory risks associated specific countries. Moreover, we may not realize the anticipated benefits of any or all of our acquisitions. As future acquisitions or mergers, we might need to issue additional equity securities, spend our cash, or incur c contingent liabilities, or amortization expenses related to intangible assets, any of which could reduce our pr and harm our business.

Risks Related to Our Industry

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

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

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

The semiconductor industry has historically been cyclical, characterized by periodic changes in business co caused by product supply and demand imbalance. When the industry experiences downturns, they often occ connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. downturns are characterized by weak product demand, excessive inventory and accelerated decline of avera prices. In some cases, downturns, such as the one we experienced from late 2000 through 2002, have lasted a year. Our business could be further harmed by industry-wide prolonged downturns in the future. The flash products portion of the semiconductor industry, from which we derive substantially all of our revenues, suff excess capacity in 2001, 2002, 2003, in late 2004 and early 2005, which resulted in greater than normal decl markets, which unfavorably impacted our revenues, gross margins and profitability. While these conditions improve during the third quarter of 2003, deteriorating market conditions at the end of 2000 through the firs and again in the fourth quarter of 2004 and the first half of 2005 have resulted in the decline of our selling p harmed our operating results.

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

Sales of our products in the consumer electronics applications market are subject to seasonality. As a result,
products are impacted by seasonal purchasing patterns with higher sales generally occurring in the second ha
year. In the past we have been able to mitigate such seasonality with the introduction of new products

throughout the year. If we fail to continue to introduce new products, our business may suffer and the season
portion of our sales may become more pronounced.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufact
sales activities. These exposures may change over time as business practices evolve and could negatively im
operating results and financial condition. Currently, we do not hedge these foreign exchange rate exposures.
sales are denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currenci
make our products more expensive and therefore reduce the demand for our products. Such a decline in the
reduce revenues and/or result in operating losses. In addition, a downturn in the economies of China, Japan
could impair the value of our equity investments in companies with operations in these countries. If we cons
of these companies to be impaired, we will write down, or expense, some or all of our investments. In 2001,
down our investment in KYE by $3.3 million to $1.3 million due to an other than temporary decline in its m
At June 30, 2005, the recorded value of our KYE investment was $3.1 million based on the quoted market p
we wrote down our investment in Apacer, a privately held memory module manufacturer located in Taiwan,
million due to an other than temporary decline in its value. As of June 30, 2005, the recorded value of our A
investment was $4.4 million. We have equity investments in companies with operations in China, Japan, Ta
United States with recorded values at June 30, 2005 of $86.7 million, $0.9 million, $16.6 million and $0.9 m
respectively.

At any time, fluctuations in interest rates could affect interest earnings on our cash, cash equivalents and
available-for-sale investments, or the fair value of our investment portfolio. A 10% move in interest rates as
2005 would have an immaterial effect on our financial position, results of operations, and cash flows. Curre
not hedge these interest rate exposures. As of June 30, 2005, the carrying value of our available-for-sale inv
approximated fair value. The table below presents the carrying value and related weighted average interest r
unrestricted and restricted cash, cash equivalents and available-for-sale investments as of June 30, 2005 (in t

Item 4. Controls and Procedures

Disclosure controls and procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be d
our reports filed or submitted pursuant to the Securities Exchange Act of 1934, as amended, or the Exchange
recorded, processed, summarized and reported within the time periods specified in the Securities and Excha
Commission's rules and forms. Disclosure controls and procedures also are designed to ensure that such info
accumulated and communicated to our management, including our Chief Executive Officer and Chief Finan
as appropriate, to allow timely decisions regarding required disclosure. A control system, no matter how wel
and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will b

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than
likelihood that a material misstatement of the annual or interim financial statements will not be prevented or
of December 31, 2004, our assessment of the effectiveness of our internal control over financial reporting id
material weakness in our internal control over accounting for and review of the valuation of inventory, the in
provision and related balance sheet accounts and licensing revenue because we lacked a sufficient complem
personnel with a level of accounting expertise that is commensurate with our financial reporting requiremen
Specifically, we lacked sufficient controls over the write down of inventory to its lower of

cost or market, accounting for complex licensing contracts with multiple elements, and processes and proced
to the determination and review of the quarterly and annual tax provisions in accordance with generally acce
accounting principles in the United States. This material weakness is discussed in greater detail in our Annu
Form 10-K for the year ended December 31, 2004.

Our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluatio
effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15
June 30, 2005. Due to the material weakness discussed above, our Chief Executive Officer and the Chief Fin
Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance
June 30, 2005.

Changes in internal control over financial reporting

During the second quarter of 2005, we implemented or began the implementation of the following remediati
address the weakness discussed above:

- We have hired new senior accounting personnel and are in the process of hiring additional accountin finance staff.
- We have continued to enhanced training programs for our accounting and finance personnel.
- We have supplemented our internal accounting and finance personnel with third party experts regard accounting and tax matters.

We expect to complete the implementation of these remedial measures during 2005 and believe that, once fu
implemented, these remedial measures will correct the material weakness discussed above.

Except as discussed above, there have been no changes in our internal control over financial reporting durin
ended June 30, 2005 that have materially affected or are reasonably likely to materially affect our internal co
financial reporting, as defined in Rule 13a-15(f) under the Exchange Act.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In January 1996, Atmel Corporation filed suit against the SST alleging that we infringed six U.S. patents. W
successfully moved for summary judgment on two of the six asserted patents in September 1997. In January
withdrew its allegation that we infringed another patent. On May 7, 2002, a judgment was entered against us
amount of $36.5 million based on a jury's fining that we infringed two of the three remaining patents. We ap
judgment on July 16, 2002. On September 12, 2003 the Court of Appeals upheld the jury's verdict. On Nove
2003 the Court of Appeals denied our request for a rehearing, and in December 2003 we paid Atmel $37.8 m
satisfy the judgment plus statutory interest accrued during the appeals. The payment was recorded as other o
expense in the year ending December 31, 2003. In addition, on June 28, 2004 we paid $247 thousand of lega
expenses incurred by Atmel pursuant to the court order.

The third patent remaining in the case, the `903 patent, expired in September 2001. The trial court has held t
found to be valid, certain of our products infringed that patent. A trial to determine whether the `903 patent i
began on July 29, 2002. On August 5, 2002 the jury announced that it was unable to reach a verdict on our in
defense, and a mistrial was declared. Atmel requested a new trial, but the Court stayed the matter until after
the earlier judgment is resolved. A new trial on the invalidity of the `903 patent was scheduled for August 1,
June 30, 2005 we signed an agreement with Atmel to settle the litigation. Under the terms of that agreement,
released us and our customers from any liability under the `903 patent and agreed to dismiss the suit with pr
return for a settlement payment. On July 27, 2005 the Court entered an Order dismissing the case.

In January and February 2005, multiple putative shareholder class action complaints were filed against SST
directors and officers, in the United States District Court for the Northern District of California, following ou
announcement of anticipated financial results for the fourth quarter of 2004. On March 24, 2005, the putativ
actions were consolidated under the caption *In re Silicon Storage Technology, Inc., Securities Litigation,* Ca
00295 PJH (N.D. Cal.). On May 3, 2005, the Honorable Phyllis J. Hamilton appointed the "Louisiana Funds
consisting of the Louisiana School Employees' Retirement System and the Louisiana District Attorneys' Ret
System, to serve as lead plaintiff and the law firms of Pomeranz Haudek Block Grossman & Gross LLP and
DeValerio Pease Tabacco Burt & Pucillo to serve as lead counsel and liason counsel, respectively, for the cl
plaintiff filed a Consolidated Amended Class Action Complaint on July 15, 2005. The complaint seeks unsp
damages on alleged violations of federal securities laws during the period from April 21, 2004 to December
Responses to the Consolidated Amended Class Action Complaint are presently scheduled to be due on Septe
2005. We intend to take all appropriate action in response to these lawsuits. The impact related to the outcor
matters is undeterminable at this time.

In January and February 2005, following the filing of the putative class actions, multiple shareholder derivat
complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of S
certain directors and officers. The factual allegations of these complaints are substantially identical to those
the putative shareholder class actions filed in federal court. The derivative complaints assert claims for, amo
things, breach of fiduciary duty and violations of the California Corporations Code. These derivative actions
consolidated under the caption *In Re Silicon Storage Technology, Inc. Derivative Litigation*, Lead Case No.
1:05CV034387 (Cal. Super. Ct., Santa Clara Co.). We intend to take all appropriate action in response to the
The impact related to the outcome of these matters is undeterminable at this time.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We
incurred certain costs while defending these matters. There can be no assurance the remaining Atmel compla

shareholder class action complaints, the shareholder derivative complaints or other third party assertions wil
without costly litigation, in a manner that is not adverse to our financial position, results of operations or cas
without requiring royalty payments in the future which may adversely impact gross margins. No estimate ca
the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, n
have been accrued in our financial statements as of June 30, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On April 11, 2005, we entered into a Share Purchase Agreement to acquire all of the outstanding capital stoc
Systems Inc., or Actrans, a company incorporated and existing under the laws of the Republic of China. Pur
terms of the Share Purchase Agreement, we agreed to issue 4,358,255 shares of SST Common Stock and ap
$4.9 million in cash to the shareholders of Actrans. On April 11, 2005, at the initial closing of the acquisitio
of the shares were issued and approximately $4.8 million in cash was paid. On May 31, 2005, 116,896 share
Common Stock were issued and approximately $131,000 in cash was paid, upon the receipt of necessary ap
the Hsinchu Science-Based Industry Park Administration of the Republic of China.

The 4,241,359 shares of Common Stock issued in the initial closing were not registered under the Securities
as amended, or any state securities laws. We relied on Rule 901 of Regulation S of the Securities Act of 193
amended, in connection with such issuance. We relied on Rule 802 of the Securities Act of 1933, as amende
connection with the issuance of the 116,896 shares of Common Stock.

Item 4. Submission of Matters to a Vote of Security Holders

Our Annual Meeting of Shareholders was held on June 2, 2005. At the Annual Meeting, the shareholders:

1. elected the persons listed below to serve as a director of SST for the ensuing year and until their suc elected,
2. ratified the selection of PricewaterhouseCoopers LLP as our independent registered public accounti the fiscal year ending December 31, 2005.

On April 19, 2005, the record date of the Annual Meeting, we had 101,311,149 shares of Common Stock ou
the Annual Meeting, holders of 89,493,156 shares of Common Stock were present in person or represented b
following sets forth information regarding the results of the voting at the Annual Meeting.

Proposal 1 - Election of Directors

Director	Votes in Favor	Withheld
Bing Yeh	87,563,775	1,929,381
Yaw Wen Hu	87,557,097	1,936,059
Tsuyoshi Taira	80,867,793	8,625,363
Yasushi Chikagami	80,530,879	8,962,277
Ronald Chwang	80,911,389	8,581,767
Terry Nickerson	87,790,131	1,703,025

Proposal 2 - Ratification of Selection of Independent Registered Public Accounting Firm

Votes in Favor	88,507,485

Votes Against	847,985
Abstentions	137,685

Item 6. Exhibits.

(a) *Exhibits.*

We incorporate by reference all exhibits filed in connection with our Annual Report on Form 10-K f
ended December 31, 2004.

10.3	1995 Non-Employee Directors' Stock Option Plan, as amended, and related form of stock option agreement. (1) PDF
10.15	Non-Employee Director Cash Retainer Program. (2) PDF
10.16	Consulting Agreement, dated May 11, 2005 and effective May 16, 2005, by and between SST and Isao Nojima. (3) PDF
31.1	Certification of President and Chief Executive Officer required by Rule 13a- 14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Vice President Finance & Administration, Chief Financial Officer and Secretary required by Rule 13a- 14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of President and Chief Executive Officer, as required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).*
32.2	Certification of Vice President Finance & Administration, Chief Financial Officer and Secretary, as required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).*

* The certifications attached as Exhibit 32.1 and Exhibit 32.2 accompany the Quarterly Rep
10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be
by reference into any filing of the Company under the Securities Act of 1933, as amended, o
Securities Exchange Act of 1934, as amended (whether made before or after the date of the
irrespective of any general incorporation language contained in such filing.

(1) Filed as Exhibit 10.3 to our Current Report on Form 8-K filed on April 21, 2005, and in
by reference herein.

(2) Filed as Exhibit 10.15 to our Current Report on Form 8-K filed on April 21, 2005, and
by reference herein.

(3) Filed as Exhibit 10.16 to our Current Report on Form 8-K filed on May 20, 2005, and i
by reference herein.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, County of Santa Clara California, on the 9th day of August, 2005.

SILICON STORAGE TECHNOLOGY, INC.

By:

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

/s/ JACK K. LAI
Jack K. Lai
Vice President Finance & Administration,
Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)